THE CITY OF LONDON LAW SOCIETY FINANCIAL LAW SUB-COMMITTEE

DIRECTIVE ON FINANCIAL COLLATERAL ARRANGEMENTS: REPLIES TO QUESTIONS FROM H.M. TREASURY CONTAINED IN NOTE OF APRIL 2003 SETTING OUT INITIAL POLICY AND LEGAL QUESTIONS

This paper sets out the replies of the Working Group established by the Financial Law Sub-Committee of the City of London Law Society to the questions raised by H.M. Treasury in their note of April 2003 on the implementation of the directive 2002/47/EC of 6 June 2002 on financial collateral arrangements (the "Directive"). For convenience, H.M. Treasury's note is reproduced in the Appendix to this paper.

The paper does not offer legal advice, but instead attempts to draw attention to issues that need to be addressed in the legislation required to implement the Directive.

The replies are based upon the laws of England and Wales at the date of this paper. Different considerations are likely to apply under the laws of other parts of the United Kingdom, particularly Scotland.

The following persons are members of the Working Party on the implementation of the Directive:

Hamish Anderson, *Norton Rose* (seconded from CLLS Insolvency Law Sub-Committee)
Lachlan Burn, *Linklaters*
Mark Evans, *Travers Smith Braithwaite*
Dorothy Livingston, *Herbert Smith* (Chairman, Financial Law Sub-Committee)
Guy Morton, *Freshfields Bruckhaus Deringer*
John Naccarato, *CMS Cameron McKenna*
Robin Parsons, *Sidley Austin Brown & Wood* (Chairman, Working Group)
Richard Slater, *Slaughter and May*
Martin Thomas, *Financial Markets Law Committee* (Secretary)
Geoffrey Yeowart, *Lovells* (Deputy Chairman, Financial Law Sub-Committee)

The views expressed in this paper are the views of the individual members of the Working Group and of the Financial Law Sub-Committee; they do not necessarily represent the views of the law firms or organisation set out opposite their names above.

Introduction/Overall Approach

We agree with the overall approach as identified in paragraph 6 of the HM Treasury note of April 2003.

Article 1 – persons within scope of implementation

We further agree (see paragraph 10) that the U.K. should not exercise the discretion given to it by Article 1(3) to exclude corporates from the scope of implementation.

We see no particular reason why the implementation of the Directive should be confined to financial collateral arrangements ("FCAs") between two financial institutions or between a financial institution and a corporate. There is no commercial logic for limiting implementation in this way; the policy for introducing the Directive as stated in its preamble is to create a community regime for the provision of securities and cash as collateral to contribute to the integration and cost-efficiency of the financial market, thereby supporting the freedom to provide services and the free movement of capital in the single market in financial services (paragraph (3)). There is no reason why this policy objective should not be applied to financial institutions which are not subject to prudential supervision, as well as corporates generally, or indeed any persons carrying on business in partnership.

However, we would suggest that individuals who are not in partnership should be excluded.

Although ambiguously phrased, our reading of Article 1.2(e) of the Directive is that it includes companies, unincorporated firms and partnerships, but not a natural person, provided that the other party is an institution as defined in Articles 1.2(a) to (d). Our suggestion that an individual (whether acting as a consumer or in the course of his business) should be excluded is therefore in line with the Directive.

We also believe that sole traders should be excluded, partly because they are not one of the persons covered by Article 1.2(e) and partly because such a person is unlikely to be entering into the kinds of transaction contemplated by the Directive. In the exceptional case, a person (such as a high net worth individual) who did wish to take advantage of the Directive could always form a company to be the counterparty to the FCA.

We believe that partnerships should be included in the implementation, though. The logic for including any partnership (even if composed only of individuals) is as follows.

A number of structured transactions in the wholesale markets involve partnerships that receive (or give) financial collateral. The reasons for using a partnership, rather than a company are sound, commercial reasons (including, for example, tax considerations). It would be confusing if the Directive were implemented so as to exclude parts of a structure involving the partnership, but applied to other parts of the same transaction that did not involve the partnership. Equally, the certainty achieved through the Directive is just as attractive where a partnership is involved as where it is not.

In addition, there are many partnerships that are very large and which include highly sophisticated individuals; in some cases, these are financial institutions such as investment or merchant banks whereas others may be professional or commercial partnerships. These partnerships may well enter into FCAs which would appropriately be put on the same footing as FCAs entered into by a corporate entity.

It may be argued, of course, that the partnership could be a small relatively unsophisticated business, perhaps consisting only of husband and wife. If the inclusion of partnerships within the ambit of the Directive would mean that the Government would find it necessary to include provisions within the implementing legislation for the protection of unsophisticated individuals (particularly if these restricted the parties' freedom to contract or overrode express contractual terms), then we would prefer that partnerships were only included within the scope of the Directive subject to a test which excluded such unsophisticated partnerships.

Another reason for including partnerships is that, to some extent, the corporate insolvency regime already extends to them. For example, a partnership can be the subject of a winding-up or an administration order or a voluntary arrangement[1]. If a partnership can be treated in the same or in a similar way to a company on insolvency, why should not it be treated in the same way for the purpose of the Directive?

We would therefore support the proposal made in paragraphs 11 and 12 of the note, but not that in paragraph 12, except in so far as the natural persons were in partnership.

Please also see the comments made under "Other points" below concerning Article 1.2(d) and securitisation.

We would reply to the questions in paragraph 12 of the note (which assumes that implementation would be extended as proposed in paragraphs 11 and 12 of the note) as follows:

a. The situations covered would include a transfer of shares or other securities or interests in securities (whether held in materialised or dematerialised form), an agreement for such a transfer (including repos), a legal or equitable mortgage, pledge or contractual lien of or on shares or other securities or interests in securities (including those held in a depository system), a sale or mortgage or charge of or on a bank, money market or other deposit of cash or a certificate of deposit, as well as netting arrangements.

   Although the Directive does not expressly state that it extends to contractual set-off, it should in our view be implemented in such a way as to do so because there is no commercial distinction between a charge on cash or a netting arrangement on the one hand and a contractual right of set-off on the other (see discussion under "Article 3 – Formal requirements" below).

   The definition of "security financial collateral arrangement" in Article 2.1(c) of the Directive is not wholly consistent with the concept of a mortgage under English law. It only covers the case where "the full ownership" of the financial collateral remains with the collateral provider when the security right is established. Under English law, a mortgage of a chose in action, such as financial collateral, constitutes an assignment of the chose by the mortgagor to the mortgagee subject to a proviso that the mortgagee should reassign the chose to the mortgagor once the secured debt has been repaid. The collateral provider does not therefore retain "full ownership" of the chose, but retains only the equity of redemption, that is, the right to require the mortgagee to reassign.

[1] The Insolvent Partnerships Order 1994.

A charge also confers a proprietary interest on the chargee so that the chargor cannot be said to retain "full ownership".

It seems certain that the Directive was intended to apply to all forms of collateral under security interest structures (see paragraph (3) of the preamble), and we would therefore wish to see the implementing legislation clearly define a security FCA in such a way as to include any form of security interest, whether or not the collateral provider retains "full ownership". It would be appropriate to refer to the collateral provider retaining "some beneficial ownership" of the financial collateral.

We reach the conclusion that the Directive extends to an equitable as well as a legal mortgage of shares because an equitable mortgage appears to fall within the definition of "security financial collateral arrangement", taken together with the explanation of the references to financial collateral being "provided", or to the "provision" of financial collateral in Article 2.2 of the Directive. These references are to the financial collateral being "delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker or of a person acting on the collateral taker's behalf". This would seem to us to be wide enough to cover a situation in which the mortgagor executes a memorandum of deposit, arranges for the share certificates to be deposited with the mortgagee and executes transfers in blank.

b. The principal advantages of this further extension are as stated in paragraphs 11 and 12. As a general principle, it can be said that there is merit in adopting a uniform approach to all FCAs, regardless of who is party to them (except, as we say above, where an individual or sole trader is involved, or where a partnership is involved if consumer protection provisions would be introduced as a result of that involvement).

c. Yes – see above.

Article 1 – Collateral within scope of implementation

We agree that there is no need in implementing the Directive in the UK to exercise the opt-out in Article 1(4)(b).

Article 3 – Formal requirements

We agree that the effect of implementing the Directive in the UK would be to disapply the requirement to register certain categories of mortgage or charge created by companies contained in Part XII of the Companies Act 1985. Such categories include a charge on book debts.

In this context, we would point out that it is in our view important that the exemption from the registration requirement should extend not only to security FCAs affecting the financial collateral itself (ie. the shares or other securities), but also to any interest or dividends or other income accruing on them. If this is not done, the collateral taker will in practice continue to register the security FCA as a mortgage or charge as a matter of caution, which will not only be cumbersome, but will raise an implication that the Directive has not been fully implemented.

Another relevant category is a floating charge. Our reading of the Directive is that it does not extend to a charge which as created was a floating charge. (We reach this conclusion based upon the definition of "provided" in Article 2.2, when read with the definition of "security financial collateral arrangement" in Article 2.1(c)).

In our view, it is essential to extend the implementing legislation so that it includes a floating charge on financial collateral (or interest or dividends or other income accruing thereon). We say this because it is often difficult to determine whether a security interest is fixed or floating in nature, particularly in the context of a security interest over a portfolio of shares or other securities where the collateral provider has rights of substitution or withdrawal.[2] Again, we would wish to avoid a situation in which the collateral taker felt obliged to register the security interest as a matter of caution to cover the risk of recharacterisation.

There are situations where it is possible for the secured party to take only a floating charge because the chargor requires freedom to deal with the charged assets in the course of its business. An example is the floating charge taken by a CREST settlement bank from the CREST member for which it acts, charging the CREST member's stock in CREST to secure its liabilities to the settlement bank. The average total value of transactions settled by CREST settlement banks is estimated to be in excess of £500 billion per settlement day (including payments generated by the self-collateralisation arrangements).[3]

The Law Commission provisionally proposed that registration or filing of a mortgage or charge on shares should be required except where the Directive applied, and that the legislation should provide that any other means of protection (eg. where the financial collateral was in the possession or control of the collateral taker) should have no effect.[4]

We believe that it is possible to construe Articles 1.5 and 3.2 in two ways.

On the first construction these Articles limit the application of Article 3.1 so that it only bites after the financial collateral has been provided. This construction would mean that there is no reason why national law should not require some formal act to be carried out before financial collateral is so provided. In other words, these Articles limit Article 3.1 in terms of time.

The alternative construction of Article 3.2 is that it is there only to make clear that Article 3.1 does not override the general principle in Article 1.5, and for no other reason. The general principle is that if the financial collateral is never provided (in the sense of never being properly delivered – see Article 2.2), then it should not be afforded the protection of the Directive.

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[2] See the guidelines given by Romer L.J. in *Re Yorkshire Woolcombers Association Limited* [1903] 2 Ch. 284. The final sentence of Article 2.2 (that any right of substitution or to withdraw excess financial collateral in favour of the collateral taker should not prejudice the financial collateral having been provided to the collateral taker as mentioned in the Directive) is helpful in this context, but is not sufficient to alleviate all concern.

[3] These charges are protected under English law as "system-charges" for the purposes of the Financial Markets and Insolvency Regulations 1996. They also benefit from the protection available under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 as CREST is a "designated system". Although these provisions provide considerable protection, this could be usefully complemented by the implementation of the new Directive.

[4] See The Law Commission Consultation Paper No.164, *Registration of Security Interests: Company Charges and Property other than Land*, July 2002, paragraph 5.25 et seq.

We are inclined to think that the alternative construction is to be preferred; if that were not the case, it would be possible for national law to retain any sort of formal restriction with regard to the creation of the security.

Articles 1.5 and 3.2 state that the Directive only applies "if the provision of financial collateral can be evidenced in writing." It is conceivable that this simply means that the Directive is not intended to apply to the provision of financial collateral which takes effect independently of being recorded in any written document – for example, the transfer of title to bearer securities by delivery.

There is a requirement under English law that a guarantee or third party security should be evidenced in writing[5]. If the alternative construction of Articles 1.5 and 3.2 mentioned above is correct, the requirement will, insofar as it relates to third party security on financial collateral, be inconsistent with Article 3, and should be expressly disapplied.

There is also a legal requirement that any transfer of certificated shares or stock should be in writing signed under the hand of the transferor.[6] In some cases, the requirement exists as a matter of contract or is contained in the constitution of the company. For example, the articles of association will normally contain a similar provision in relation to a transfer of shares in the company.[7] In addition, dealings in securities held in the depository systems may be required to be in writing under the terms of the rules of the system.

The prohibition in Article 3 only relates to the requirements of Member States, not requirements imposed by contract or a company's constitution (which, of course, takes effect as a contract between the shareholders[8]). Care should be taken in the implementing legislation to ensure that the parties should remain free to impose by contract any further requirements that they think fit.

If the alternative construction of Articles 1.5 and 3.2 mentioned above is correct, it is arguable that the *legal* requirement that the transfer of certificated shares or stock should be in writing is inconsistent with Article 3. The contrary argument is that the transfer of the shares or stock is not an "arrangement" per se although it could conceivably be used as part of such an arrangement if the arrangement itself was "for the purpose of securing or otherwise covering the performance of relevant financial obligations" (see Article 2.1(b)) or was for the provision of financial collateral by way of security (see Article 2.1(c)).

In the final analysis, the answer may not matter very much because the articles of association will invariably provide that any transfer of certificated shares must be in writing signed by the transferor. We are inclined to think that the implementing legislation should not expressly repeal section 1(1) of the Stock Transfer Act.

Any written transfer of shares or other securities which is entered into by way of security or by way of re-transfer to the original transferor on release of that security is (unless it falls within an exemption, for example, for a transfer of "loan capital") liable to a fixed stamp duty of £5.00.[9] We consider that the requirement to pay such duty is a requirement that "the ….

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5 See s.4 of the Statute of Frauds 1677.
6 See s.1(1) of the Stock Transfer Act 1963.
7 Companies Act 1985, Table A, paragraph 23.
8 See *Hickman v. Kent or Romney Marsh Sheep-Breeders' Association* [1915] 1 Ch. 881.
9 See Finance Act 1999, Schedule 13, paragraph 16. The view generally taken is that the transfer would not be exempt under paragraph 25 of the Schedule as a "mortgage" even though its transfer would have the effect of

admissibility is evidence of a financial collateral arrangement or the provision of financial collateral under a financial collateral arrangement be dependent on the performance of [a] formal act." We therefore take the view that stamp duty under this head should be abolished.

Any written transfer of shares or other securities which is entered into by way of a repo or as part of a stock lending arrangement will normally be exempt from both stamp duty and stamp duty reserve tax, but only if the transfer is effected on an EEA exchange or a "recognised foreign exchange" on which the shares or securities are "regularly traded".[10] The definition of financial instruments in Article 2.1(e) would seem to indicate that securities will only be included within the definition if they are traded on the capital market or dealt in on some other market. It is possible, for example, that UK equities could be traded on some market other than an EEA exchange or "recognised foreign exchange", and that these securities could be the subject of a repo or stock lending arrangement. Consideration should therefore be given to extending the repo and stock lending exemption from stamp duty and stamp duty reserve tax to cover the provision of financial collateral under a title transfer FCA in such circumstances.

There is also a rule of law that any disposition of an equitable interest or trust subsisting at the time of the disposition in relation to property of any description must be in writing signed by the person disposing of the same, or by his agent.[11]

If the alternative construction of Articles 1.5 and 3.2 is correct, it would again seem that, in so far as the equitable interest is an interest in financial collateral, the requirement should be expressly disapplied.

We understand that this section's predecessor (section 9 of the Statute of Frauds 1677) was enacted to prevent fraud. We suspect that in the present world the section serves little purpose, and no real harm would be caused if it were to be repealed or at least disapplied in so far as it relates to financial collateral.

It is, of course, very common to effect dispositions of financial instruments and cash by will, and (with limited exceptions) a will must be in writing and signed in the presence of at least two witnesses.[12] However, it would be most unusual for a will to be part of a financial collateral arrangement.

We are a little concerned that Article 3.1 might have some effect on the rule that an assignment of a debt (such as a deposit with a bank) cannot take effect at law unless notice of the assignment is given to the debtor[13] (in the example, the bank) or that the priority of the assignment is determined by the order in which notice of competing assignments is given to the debtor under the Rule in *Dearle v Hall*.[14] Notice of assignment also has the effect of preventing further equities arising as between the debtor and the assignor (in the example, the depositor) in priority to the rights of the assignee.

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creating a legal mortgage of the shares or securities concerned. The position in relation to shares held in CREST is that, under arrangements agreed with the Inland Revenue, the parties will at the time of creation of the mortgage execute a "letter of direction", and this letter of direction is chargeable to fixed stamp duty of £5.00.

[10] See ss.80C and s.89(AA) Finance Act 1986.

[11] See s.53(1)(c) Law of Property Act 1925.

12 See s.9 Wills Act 1837.

[13] s.136 Law of Property Act 1925.

[14] [1828] 3 Russ. 1.

We do not believe that Article 3.1 was intended to dispense with these principles which are both well established and founded upon good common sense. The answer may be that Article 3 only applies to financial collateral which is "provided", and that where the assignment is "silent" (i.e. notice is not given to the debtor), the financial collateral has not been "provided" within the meaning of Article 2.2 because the deposit is not in such circumstances "in the possession or under the control of the collateral taker", even if the assignee (the collateral taker) has an immediate right to give notice to the debtor.

It is tempting to suggest that "control" should be defined so as to clearly exclude such a situation. However, we think that on balance it is better to resist the temptation and leave the meaning of "control" to be decided by the courts who are likely to apply common sense and preserve a rule which has served the commercial community well over the years.

There would, nevertheless, be advantage in making it clear (as has been done in Article 9 of the Uniform Commercial Code in the United States)[15] that "control" includes "control" in the negative sense (eg an undertaking by a custodian not to part with financial collateral without the consent of the collateral taker, even if there is no undertaking to deliver or pay it to the collateral taker on demand).

We do not believe that the Bills of Sale legislation does apply to financial collateral.

Furthermore, we consider that it is probably not necessary to disapply Section 344 Insolvency Act 1986 (the "1986 Act") for two reasons. First, it is unlikely that any FCA will amount to a general assignment of book debts, or any class of them. Secondly, assuming that it is decided not to extend the implementing legislation to individuals as distinct from partnerships, the Section would not in our view apply as the book debts would not be available to any individual bankrupt's estate (on a winding up or dissolution of a partnership, the trustee of an individual partner would normally only be entitled to the individual's share of net partnership assets after discharging the partnership debts).

Although this is our view, there has been very little case law on Section 344 and the position is not completely free from doubt. Moreover, the consequences of a failure to register the assignment set out in Section 344(2) are potentially extremely serious. For these reasons, it may be prudent to disapply Section 344 to dispel any doubt.

Where the security FCA consists of an equitable mortgage of shares or other securities, it is not thought that any action required to convert the equitable mortgage into a legal mortgage would be prohibited by Article 3.1. Although the registration of the transfer might be regarded as a means of perfecting or enforcing the FCA, the better view would appear to be that the FCA is the equitable mortgage itself and that the equitable mortgage is complete upon its execution, and its perfection or enforcement does not depend upon the registration of the transfer (paragraph 10 of the preamble states that the recording on the issuer's register of a registered instrument should not be regarded as a "formal act").

The Directive should be implemented so as to cover cash collateral, whether created by using the technique of charge or set-off. The most common methods of taking cash collateral under English law involve either using an equitable charge where the cash deposit or credit balance is held by the charge holder (or a security assignment where it is held by a third party deposit holder) or relying on a right of set-off. Market practitioners must be free to choose, on a

[15] See paragraph 9-104 of the United States Uniform Commercial Code.

transaction by transaction basis, which method is most appropriate and each method should be protected equally when the Directive is implemented.

Set-off may be preferable to a charge in a number of situations, even after Article 3 is implemented. Set-off is unaffected by more traditional negative pledges. It also avoids concern as to whether the charge is fixed or floating. Unlike a floating charge, set-off is not subject to claims of preferential creditors, or the risk that an administrator of the depositor (if appointed) could use the cash collateral to pay his own remuneration and expenses and liabilities incurred by him in the course of the administration under Sections 19(4) and (5) of the 1986 Act, or the risk of challenge under Section 245 of that Act.

Set-off also lies at the heart of many cash management arrangements offered by banks to groups of companies. Typical features of these systems are that (i) the bank agrees, for the purpose of calculating interest, to deduct credit balances from debit balances on the current accounts of the group companies participating in the system, (ii) each participant authorises the bank to set off money standing to its credit on its account within the system against the indebtedness to the bank on the accounts of the same or any other participant, (iii) each participant is permitted to utilise a group overdraft facility subject to guaranteeing, or being liable as a co-obligor for, the indebtedness to the bank of each other participant. Such systems offer corporate customers a saving in interest and improved risk management for banks. A UK bank is permitted to report to the Financial Services Authority (the "FSA") on a net basis in relation to debit and credit balances within such systems, provided that certain criteria are fulfilled: see the Interim Prudential Sourcebook: Banks, Volume 2, NE Section 7. In particular, the bank is required to obtain an opinion from its legal advisers in each relevant jurisdiction that the bank's right to set off credit balances against debit balances under such arrangements is legally well-founded and enforceable in the default, liquidation or bankruptcy of the customer or depositor. If the Directive is implemented to cover set-off over cash deposits or credit balances, it will be easier to obtain "clean" legal opinions for this purpose under English law.

We are not aware of any other registration or procedural formalities which would, or might, need to be disapplied.

Article 4 – Enforcement by appropriation

We agree that the collateral taker will normally enforce a security FCA by sale or other disposal[16], but in certain cases he may appoint receivers to collect the income and, if permitted by the terms of the security FCA, to manage the business.

Where the security FCA affects cash, the collateral taker may enforce his rights by appropriating the cash (or, to be more exact, the debt that has been mortgaged or charged to him) to discharge pro tanto the secured debt.

Where the security FCA affects an asset other than cash, it is unusual for the collateral taker to appropriate the asset transferred to him so as to acquire absolute ownership in return for the secured debt being extinguished.

[16] See s.101 and s.103 Law of Property Act 1925.

To the extent that it is permissible to include a contractual provision permitting appropriation, this should continue to be permitted and the UK should not opt not to recognise it (see Article 4.3).

Where appropriation is through a court process, this is called foreclosure[17] which is a remedy that can only be resorted to pursuant to an order of court.[18]

If the contract validly provides for appropriation and a means of valuation, the parties' freedom to contract should be respected and effect should be given to the contract.

In a situation in which the contract does not provide for appropriation, we agree that the effect of Article 4(4)(b) will be that the implementing legislation will have to remove the need for a court order in any foreclosure by the collateral taker. We also agree that it will be necessary, if such a remedy is to be permitted, for objective standards to be applied to its exercise.

The remedy of foreclosure is not much used in practice, largely because of the need to obtain a court order, but it can be useful in structured transactions, and would perhaps be more used if the law were more friendly towards it. The power of sale and the power to appoint a receiver, coupled with (in the case of cash) the right to appropriate and apply, are the usual remedies and they would appear to be adequate in most cases; but a more user friendly form of appropriation would give an additional flexibility to the structured finance markets that would be welcome.

We therefore believe that foreclosure should be retained as a remedy. Consequently, in a security FCA the requirement of a court order would have to be abolished to comply with Article 4(4)(b).

In the absence of a contractual provision dealing with valuation, we would prefer that the valuation test should follow as closely as possible the principles established by existing case law where a mortgagee exercises his power of sale (the "best price reasonably obtainable at the time"[19]). We see no reason why the principles applicable to a sale by a mortgagee should not be adapted to cover the case of appropriation by a mortgagee; there is indeed commercial logic in having the same test apply to both situations.

Where the collateral is traded on a recognised market, there could be a presumption that the mark-to-market valuation represented the best price reasonably obtainable or the proper value. The Directive describes the practice of limiting credit risk by mark-to-market calculations of the current market value of the credit exposure and the value of financial collateral as a "sound market practice favoured by regulators" (see paragraph (16) of the preamble).

In the case of an equitable mortgage, the mortgagee may as a matter of expediency require an order for sale from the court or an order that the directors register a transfer in favour of the mortgagee or its nominee, notwithstanding a discretion conferred upon them by the articles of association to decline to register any transfer. Subject to one qualification, there is no reason why these procedures should change under the new regime because, assuming that the

[17] See *Law of Mortgage*, Fisher & Lightwood, 11th Edition, Chapter 22.
[18] Ibid at paragraph 22.1.
[19] See *Downsview Nominees Ltd v. First City Corpn Ltd* [1993] AC 295 ((1994) 45 NILQ 61 (Fealy)); *Tse Kwong Lam v. Wong Chit Sen* [1983] 3 All ER 54, [1983] 1 WLR 1349 at 1355.

mortgage was executed as a deed, the power of sale would exist and there would be no requirement that the court approve its exercise[20] so that the existing rules do not offend against Article 4.4.

There is one situation in which the procedures would need to change under the new regime. Where the power of sale could not be exercised for any reason, perhaps because there was no power of sale because the mortgage was not executed as a deed, perhaps because a transfer could not effectively be executed because the securities remained in the name of the collateral provider and not in the name of the collateral taker or its nominee, then it would be necessary to apply to the court for an order for sale. Furthermore, if the collateral provider was in compulsory liquidation, leave of the court would need to be obtained before the proceedings were commenced.[21] In a voluntary liquidation, the liquidator would have power to apply to the court to have the proceedings stayed.[22]

This could be dealt with in part by abolishing the somewhat outdated idea that a power of sale will be implied only when the mortgage is executed as a deed. The requirement that leave of the court need be obtained or the right of the liquidator to apply to have the proceedings stayed could be removed; certainly, in the first situation the court tends to grant leave as something of a formality. It would be more difficult as a practical matter to remove the practical necessity of applying to the court for an order for sale where the securities remain in the name of the collateral provider or his nominee, and we do not think that there is any requirement in Article 4.4 to do so.[23]

Another statutory provision that could conflict with Article 4.4(b) is Section 91(2) of the Law of Property Act 1925 which provides that a mortgagor can apply to the court for an order for sale. It has been held[24] that this gives the court an unfettered discretion to direct a sale against a mortgagee's wishes even if the sales proceeds would not be sufficient to discharge the mortgage debt. This is a fetter on the mortgagee's freedom to realise the mortgaged property at a time of his choosing and effectively gives the court power to approve the terms of realisation contrary to Article 4.4(b). Section 91(2) should therefore be disapplied in so far as it could relate to financial collateral.

We would discourage any attempt to replicate the terms of Article 4.6 in the implementing legislation.

We say this for two reasons:

First, we do not believe that there are any requirements of national (English) law to the effect that the restriction or valuation of financial collateral and the calculation of the relevant financial obligations must be conducted "in a commercially reasonable manner such as to affect Articles 5, 6 or 7".[25] If there are no such requirements, it would be misleading to replicate Article 4.6 so as to imply that there are.

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[20] Section 101 Law of Property Act 1925.
[21] See s.126 and s.130 of the 1986 Act.
[22] See s.112 of the 1986 Act.
[23] The court is not being asked to approve the terms of realisation of the financial collateral within Article 4.4(b).
[24] *Palk and another v Mortgage Services Funding plc* [1993] 2 All ER 481, [1993] Ch. 330.
[25] The nearest equivalent principles would appear to be the *Downsview* principle, the treatment of penalties under English law and the statutory provisions allowing for the reopening of extortionate credit transactions

Secondly, even if our suggestion that partnerships should be included is accepted, the parties to the FCA must be treated as financially aware and capable of understanding the contract that they are entering into. It would be wrong and damaging to the financial markets to impose some test of commercial reasonableness which was not reflected in the wording of the contract. This would only lead to uncertainty which would not be conducive to the effective running of the financial markets.

Articles 4 and 7 – Administration

We agree that the statutory bar on the enforcement of security when a company is in administration will need to be disapplied in the case of a security FCA.

It will also be necessary to disapply section 11 of the 1986 Act[26] which requires the receiver to vacate office at the request of an administrator, in so far as it may relate to a receiver appointed under a security FCA.

It will also be necessary to remove the administrator's right to apply to the court for an order for the sale of financial collateral subject to fixed security and (if our recommendation regarding floating charges is accepted) to remove the administrator's statutory power to deal with financial collateral subject to security which as created was a floating charge.[27]

Even after the relevant provisions of the Enterprise Act 2002 (the "2002 Act") have come into force, it will be possible for the company or its directors or a creditor to apply to the court for an administration order[28], and the statutory bar will apply from the date the application is made[29]. This bar will also need to be disapplied.

It is not absolutely clear that administration proceedings that are commenced by the filing of a notice of appointment by the holder of a qualifying floating charge or by the company itself or its directors amount to "reorganisation measures" within Article 2.1(k). This is because the filing of the notice under paragraphs 18 or 27 of Schedule 16 to the 2002 Act may not amount to an "intervention" by judicial authorities. It would be possible to make the alternative argument that the administrator is an officer of the court, and the company is under his supervision and control, so that the appointment of an administrator does involve the "intervention by administrative or judicial authorities", even where the appointment is not made by the court but by the holder of a qualifying floating charge. We think that this argument would be likely to succeed, but we would nevertheless recommend that the position should be made clear.[30]

It will further be necessary to disapply the statutory bar on the enforcement of security which arises in relation to small companies on proposing a moratorium.[31]

A company voluntary arrangement (a "CVA") once approved, or a scheme of arrangement (a "Scheme") once sanctioned, may affect the rights of a collateral taker under a security FCA.

(sections 244 and 343 of the 1986 Act; cf. ss.137-139 of the Consumer Credit Act 1974 which deal with extortionate credit bargains).

[26] See paragraph 41(2) of Schedule B1 to the 1986 Act to be inserted by s.248 of the Act.

[27] See s.15 of the 1986 Act and paragraphs 70 and 71 of Schedule B1 to the 1986 Act to be inserted by s.248 of the 2002 Act.

[28] See paragraph 12 of Schedule B1 to the 1986 Act to be inserted by s.248 of the 2002 Act.

[29] See paragraph 44 of Schedule B1 to the 1986 Act to be inserted by s.248 of the 2002 Act.

[30] See "Other points" infra.

[31] See s.12 of the Insolvency Act 2000.

However, a CVA does not of itself constitute "winding-up proceedings" or "reorganisation measures" within the terms of the Directive[32] and so there is in our view no need to disapply the legislation which gives effect to it. A Scheme will not take effect unless sanctioned by the court and that is a measure which involves intervention by judicial authorities. Where used as an exit from administration, the Scheme is also normally intended to restore the company's financial situation and, by effecting a compromise or arrangement with the company's creditors, it affects the pre-existing rights of third parties.

In our view, there is no logical reason for distinguishing between a CVA and a Scheme, and we would therefore recommend that the implementing legislation should provide that neither of them should prevent a financial collateral arrangement or a close-out netting provision taking effect in accordance with its terms.

Apart from this and the insurance companies legislation quoted in the note, there are a number of other legislative provisions that will need to be dealt with, including those that provide for special administration orders.[33]

We strongly support an express disapplication of the relevant statutory provisions in the implementing legislation.

Article 5 Right of use

We do not believe that it is already the case under English law, in the absence of an express provision in the instrument creating the security, that a mortgagee[34] has the right to use the asset mortgaged to him.

Although as a matter of legal fiction a mortgagee may have a right to possession from the moment that the mortgage is executed[35], this right is in practice subject to a number of restrictions[36] and in any event cannot be equated to a right to use the asset.

Nor is it usual to include any provision in the instrument creating the security conferring a right to use the mortgaged property. The right of use has been available under title transfer FCAs for some time: it is the basis of all stock lending arrangements and it is also a feature of a repo. It is becoming more common in prime brokerage transactions where investment banks take the assets of hedge funds by way of security. Nevertheless, it would be quite exceptional to see a case in which a mortgage conferred upon the mortgagee a right to use shares or securities mortgaged to a bank in a retail banking context. We understand that the concept of conferring a right upon the collateral taker to re-use by repledging the pledged

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[32] The definitions in Articles 2(i), (j), and (k) require "intervention by administrative or judicial authorities". A CVA does not involve any such intervention (although, if the nominee is not the liquidator or administrator of the company, he is required to submit a report to the court). The court's role in such a case is an administrative one, and the court does not of its own motion intervene in any way.

[33] These include the special administration regimes provided in the Water Industry Act 1991, the Railways Act 1993, the Transport Act 2000, the Greater London Authority Act 1999, and the Building Societies Act 1986. See further the DTI Consultation Paper, *"Proposals for a special administrator regime for energy network companies"*, 16th April 2003.

[34] Although we will refer throughout to a "mortgage", a "mortgagee", a "mortgagor" and "mortgaged asset" etc., our remarks are intended to apply equally to other forms of possessory and non-possessory security such as a pledge or a charge.

[35] See *Law of Mortgage*, Fisher & Lightwood, 11th Edition, paragraph 19.1; *Birch v. Wright* (1786) 1 Term Rep 378.

[36] Ibid at paragraph 19.2.

assets to a third party on the condition that the rights of the collateral provider are completely respected is one that exists under the laws of some Continental European jurisdictions.[37]

However, if the instrument creating the security (or some other contract forming part of the arrangement) were to expressly authorise a right of use on the terms described in Article 5, our view is that the right of use would be effective, since it would neither be a clog on the equity of redemption, nor otherwise an unlawful collateral advantage within the tests laid down in the case law.[38] If the right of use is expressly authorised by the implementing legislation, there can in any event be no basis for setting it aside on these grounds.

Whatever the position under the existing law, the Directive now requires the U.K. to resolve any doubt on the issue in favour of the validity of the right of use.

The grant by the collateral provider to the collateral taker of a right of use could potentially have serious consequences for the collateral provider should the collateral taker become subject to an insolvency process; if, for example, the collateral taker under a security FCA where there is no right of use were to go into liquidation, the collateral provider would have a proprietary interest in the mortgaged asset so that the asset would not form part of the estate available to the creditors of the collateral taker in the winding up, whereas the converse would apply if the security FCA conferred a right of use, at least until "equivalent collateral" were actually provided.

It seems that the intention of Article 5.3 of the Directive is to confer a proprietary interest upon the collateral provider, but until the "equivalent collateral" has been identified by appropriation on the part of the collateral taker, the proprietary interest cannot take effect because the subject matter of the "equivalent collateral" will not be ascertainable.

Once the "equivalent collateral" has been ascertained[39], the effect of Article 5.3 is to deem it to have been the subject of the same security FCA to which the original financial collateral was subject and it is treated as having been provided at the same time as the original financial collateral was first provided.

This presents its own problems. If the "equivalent collateral" appropriated to the security FCA were to be sold or mortgaged to a third party before appropriation and the original collateral security taker were to go into liquidation, would the interest of the collateral provider under the security FCA rank ahead of the interest of the innocent third party purchaser or mortgagee by virtue of the provision which deems it to have been created first in time? (It may be that this problem is more theoretical than real because the collateral provider could never acquire an interest in the equivalent collateral until it was ascertained, and it would never be ascertained if a liquidation supervened before appropriation).

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[37] See the Explanatory Memorandum to the Draft Directive of the European Parliament on the Financial Collateral Arrangements, dated 27th March 2001.

[38] Notably, *Kreglinger v New Patagonia Meat and Cold Storage Company Limited* [1914] A.C. 25.

[39] This can only happen when the equivalent collateral has been "transferred in discharge of the obligation as described in paragraph 2" (see the opening words of Article 5.3), that is, when it has been transferred so as to replace the original collateral. In practice, we take this to mean, in the context of securities within a depository system, that equivalent collateral can be returned by causing it to be recredited to the mortgaged account, whereupon the mortgage will reattach with, in substance, retrospective effect in accordance with the final words of Article 5(3) and with Article 5(4). In the interim period, while the obligation to transfer equivalent collateral remains outstanding, the mortgagor will not have a proprietary interest, but merely a contractual right of delivery.

It is suggested that the Treasury should seek guidance from other jurisdictions whose national laws permit the collateral taker a right of use in order to discover how these problems have been dealt with and how the right to use has operated in practice. This could be achieved through relevant official contacts at the EU level, or, if it is preferred to seek expert views from the commercial sector, we would be happy to suggest ways that this might be achieved.

The right of use allows the mortgaged securities to be used to create multiple obligations between different parties. The resulting obligations will amount to a corresponding multiple of the value of the securities. Some concern has been expressed that this should give rise to supervisory concerns. However, the risks are familiar to supervisors in the context of repos, and, where the bargaining power is equal, the collateral provider can limit the extent to which the collateral taker is permitted to use the securities.[40]

Against this, the right of use will give additional liquidity to the collateral taker, and the availability of the financial collateral may be reflected, at least in the wholesale markets, by more favourable pricing in favour of the collateral provider – indeed those prime brokers who already include a right of use in their documentation say that they do so at least partly because they believe that it gives them economic advantage which can be reflected in keener financing terms.

We recommend that the Treasury should hold discussions with the FSA with a view to ensuring that, where the right of use becomes available, the FSA has in place systems for monitoring and controlling the extent to which institutions which it supervises have exposures under FCAs entered into by them to the multiple use by collateral takers of financial collateral provided by them.

Article 6 – No recharacterisation

We agree that, although the risk of recharacterisation is limited under English law, the implementing legislation should give effect to Article 6(1) in explicit terms.

Article 7 – Recognition of close-out netting provisions

If the close-out netting provision has been properly drafted (and, in particular, in such a way as not to be inconsistent with the mandatory set off provisions contained in Rule 4.90 of the Insolvency Rules 1986 (the "Rules")), we know of no reason why effect should not be given to such a provision in a winding up of one of the parties under English law. We are not aware of any requirement under English law to the effect mentioned in Article 4.4 which needs to be disapplied.[41]

Close-out netting will be subject to Rule 4.90(3) which provides that sums due from the company to another party shall not be included in the account taken under the mandatory set-

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[40] The opening words of Article 5(1) ("If *and to the extent that* the terms of a security financial collateral arrangement so provide") make it clear that such limitation will be effective.

[41] Article 4.4 provides that the manner of realising the financial collateral shall be without any requirement to the effect that the terms of the realisation be approved by any court (see paragraph (b)). Although s.127 of the 1986 Act provides that any disposition of the company's property after the commencement of a compulsory winding-up is void "unless the court otherwise orders", it is generally thought (see The Law of Set-off, 3rd Edition, S.R. Derham, paragraph 6.109) that, notwithstanding the statement of Nourse J. in Barclays Bank Limited v TOSG Trust Fund Limited [1984] BCLC 1, 25-26, the insolvency set-off under Rule 4.90 must prevail over s.127 because it will always operate after the commencement of a compulsory winding-up (the date of the petition) because it takes effect, in such a winding-up, on the date of the winding-up order.

off if that other party had notice at the time that they became due that a meeting of creditors had been summoned for the purpose of a voluntary winding-up or that a petition for the winding up of the company was pending.

This provision is not covered by Article 7.1(a) which is limited to the "commencement or continuation of winding-up provisions or reorganisation measures" – the notice of the creditors' meeting or the presentation of the petition does not commence the winding up (although, in the case of the petition, the winding up order, once made, will relate back to the date of the petition).[42]

We consider that Rule 4.90(3) does serve a useful function in preventing a party from continuing to deal with a company at a time when he knows that liquidation is imminent on terms that could work to the prejudice of the company's creditors. We therefore recommend that the implementing legislation makes it clear that Rule 4.90(3) will continue in force.[43]

Liquidation procedures under the Rules are conducted in sterling. Rule 4.91 of the Rules provides that, for the purposes of proving a debt incurred by the company in liquidation in a currency other than sterling, that debt shall be converted into sterling at the "official exchange rate" (which is based on the market rate on the date the court makes the winding up order or the company resolves that it should be wound up). Therefore, a close-out netting provision may not take effect in accordance with its terms if it provides for conversion on close-out to take effect at some other rate. We would wish the implementing legislation expressly to disapply Rule 4.91 in such a case. As the definition of "close-out netting provision" in Article 2.1(n) envisages that the provision may estimate current value, we believe that the implementing legislation is required to disapply Rule 4.91.

Under Section 178 of the 1986 Act, the liquidator of a company may, by giving notice, disclaim any onerous property of the company. "Onerous property" is defined to include any "unprofitable contract" and "any other property of the company which is unsaleable or not readily saleable or is such that it may give rise to a liability to pay money or perform any onerous act". A disclaimer operates to determine, as of the date it is made, the "rights, interests, and liabilities of the company in or in respect of the property disclaimed". Any person sustaining loss or damage in consequence of the disclaimer is deemed a creditor of the company to the extent of the loss or damage and may prove for that amount in the winding up.

In bilateral netting arrangements, a liquidator's right to disclaim rarely gives rise to a problem in practice because the master or other agreement providing for the netting makes it clear that the agreement forms a single contractual agreement with the result that the liquidator cannot "cherry pick".

It would nonetheless in our view be desirable to make it clear that the close-out netting provision should take effect in accordance with its terms, and that Section 178 should not apply so as to prevent this happening. Section 186 of the 1986 Act, which gives the liquidator the right to apply to the court for an order rescinding a contract, should be disapplied in a similar manner.

[42] Section 129(2) 1986 Act.
[43] This is permissible: see paragraph (15) of the preamble to the Directive.

The disapplication would ideally extend to all FCAs, and not just close-out netting arrangements (in the same way as section 164 of the Companies Act 1989 disapplies the sections to all market contracts).

The ability of a party under a properly drafted netting agreement to close out and net an existing transaction against the counterparty is not in general affected if the claims owed to the counterparty are assigned or charged to a third party or attached by a judgment creditor of the counterparty, provided that, broadly, the relevant party had no notice of the assignment, charge or attachment at the time of entering into that transaction. We are not, therefore, aware of any other circumstances which may need to be covered, or specific legal rules which may need to be disapplied, in the context of FCAs in order to give effect to Article 7.1(b).

The principles stated above assume that the transactions are mutual in the sense that there are only two parties owning and owing claims between themselves[44]. Transactions by a party with an agent acting on behalf of one client would not normally be mutual with transactions with another client acting through the same agent. We do not think that any special provision need be included in the implementing legislation to deal with this as the definition of "close-out netting provision" makes it clear that the Directive is only dealing with a provision which allows account to be taken of sums due from one party to the other, and sums due from a third party are not brought into the account.[45]

However, we do think that it is desirable to include special provision with regard to specialist counterparties, such as unit trust and other non-incorporated trust funds, building societies, statutory corporations, insurance companies, municipalities and other entities that are subject to a special regime. Although the Directive by its terms applies if the counterparty is a public authority or a regulated financial institution, it is not intended to address rights arising from lack of capacity[46]. Notwithstanding this, our view is that the opportunity should be taken to ensure that a party contracting with a counterparty which is subject to a special regime should be free to do so without needing to concern himself that the counterparty is complying with that regime[47].

We do not consider that there is anything that the Treasury need do to implement Article 7(2).

Article 8

We agree that it will be necessary to disapply Section 127 of the 1986 Act in order to implement Article 8.

Section 127 only applies to a winding up by the court. It only deals with dispositions of the company's property made after the commencement of winding-up, which will normally mean after the presentation of the petition.[48]

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[44] Paragraph (3) of the preamble to the Directive states that the Directive focuses on bilateral FCAs.
[45] Also paragraph (15) of the preamble makes it clear that the Directive is without prejudice to any restrictions or requirements under national law on netting.
[46] Paragraph (6) of the preamble to the Directive.
[47] c.f. the interest rate swap transaction cases such as Hazell v Hammersmith & Fulham London Borough Council [1992] 2 AC 1, HL.
[48] s.129 of the 1986 Act.

We suspect that Article 8.1(a) was conceived to dispense with the "zero hour rule" under which in some jurisdictions the winding-up order was deemed to relate back to the first moment of the day on which the order was made so as to invalidate transactions taking place during the day.

In England, the effect of making a winding-up order is to relate the winding-up back, not to the first moment of the day on which the order was made, but to the date of the winding-up petition, which is likely to be some weeks earlier. We suspect that the application of the "zero hour rule" would render the winding-up effective from the first moment of the day upon which the winding-up petition was presented.

If section 127 is disapplied, the effect is therefore likely to be of much more significance than would be the case if only the "zero hour rule" was affected. It would effectively mean that financial collateral disposed of by the company after the commencement of the winding-up would cease to be available to the general body of unsecured creditors.

This may be justifiable in the interests of financial certainty, but could give rise to injustice if the financial collateral was transferred, for example, to secure antecedent debt in circumstances in which the transfer could not be set aside as a preference because it did not take place in the period of six months (or in the case of a preference given to a person connected with the company) two years ending with the onset of insolvency.[49]

Our proposal would therefore be that section 127 should be disapplied, but the provisions dealing with the avoidance of antecedent transactions should be amended so that, for this purpose only (and not, for example, for the purpose of affecting "collateral security charges" under regulation 17 of the Settlement Finality Regulations[50]), the "onset of insolvency" would be deemed to take place at the date of the winding-up order. We also consider it important that Rule 4.90(3) of the Rules is retained.

Section 127 does not apply in the case of a voluntary winding-up. In the case of a creditors' voluntary winding-up, the directors' powers cease on the appointment of the liquidator[51] and their power to act until the appointment is strictly limited.[52] The winding-up is deemed to have effect when the resolution is passed;[53] in other words, there is no relation back and no zero hour rule.

There is no requirement under the Directive to disapply these provisions, and we see no reason to do so.

Our reading is that Article 8 is not intended to prevent avoidance of the transaction under Sections 238 (transactions at an undervalue (England and Wales)), 239 (preferences (England and Wales)), 242 (gratuitous alienations (Scotland)), 243 (unfair preferences (Scotland)), 244 (extortionate credit transactions) and 245 (avoidance of certain floating charges) and 423 (transactions defrauding creditors) of the 1986 Act. However, we think that section 245 requires special treatment (see below).

[49] s.240 of the 1986 Act.
[50] Directive 98/26/EC of 19 May 1998 on settlement finality in payment and securities settlement systems.
[51] s.103 of the 1986 Act.
[52] s.114(2) of the 1986 Act.
[53] s.86 of the 1986 Act.

We reach this conclusion because Articles 8.1 and 8.3 require Member States to ensure that a FCA may not be declared void "on the sole basis" that it came into existence on the day of the winding up proceedings etc or (in the case of Article 8.1) a prescribed period prior to the commencement of such proceedings or (in the case of Article 8.2) after the relevant financial obligations were incurred. Each of the provisions mentioned only allows the avoidance of the antecedent transaction if some other element is present (for example, in the case of Section 239, a desire to prefer on the part of the person giving the preference[54]). Moreover, Article 8.4 makes it clear that the general rules of national insolvency law in relation to the voidance of transactions entered into during the prescribed period remain unaffected.[55]

Paragraph (16) of the preamble is a little misleading in that it expressly preserves the possibility of questioning under national law the FCA and the provision of financial collateral as part of the initial provision, top-up or substitution, "for example where this has been intentionally done to the detriment of the other creditors". The words in parenthesis which follow state that this covers actions based on fraud or similar voidance rules which may apply in a prescribed period.

The question arises whether an action, for example, to set aside a transaction at an undervalue, where it is not necessary to plead as part of the cause of action any specific intent on the part of the company or its directors, is nevertheless a voidance rule which is "similar" to fraud. In our view, the Directive was not intended to prevent a transaction being set aside as a transaction at an undervalue.

If the Directive does not require any amendment to the rules under English law for the avoidance of antecedent transactions, the question arises whether the Government should take the opportunity of the implementing legislation to amend those rules.

We have already mentioned the need, if section 127 is to be disapplied, to amend the definition of "onset of insolvency" for the purpose of dispositions made by a company under an FCA.

Section 245 of the 1986 Act provides that a floating charge created by a company on its undertaking or property at a relevant time is invalid except to the extent of "new money" etc. Section 245 is unique in the legislation dealing with the avoidance of antecedent transactions in that there are no other requirements of avoidance; in particular, there is no necessity to show wrong-doing or intent.

If our suggestion concerning the extension of the Directive to floating security is accepted, we believe that it will be necessary to disapply section 245 in order to give effect to Article 4.5 because the floating charge will not take effect in accordance with its terms if it is created at a relevant time.

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[54] Section 239(5) 1986 Act.

[55] The Working Document on Collateral from the European Commission to Relevant Bodies for Consultation (15.6.2000) contained passages (for example, at the end of page 12 and on page 15) indicating that it was intended that top-ups and substitutions should be vulnerable only to the extent that the FCA itself was vulnerable; indeed this was the formulation used in the contemporary text of what was then Article 10. The current text is narrower than this and provides protection against invalidation on the grounds of timing alone or on the ground of provision in respect of pre-existing liabilities. The formulation in Article 8(2) follows the corresponding wording of the Settlement Finality Directive (see footnote 34 below), reflected in Regulation 20 of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 – a provision which causes a certain amount of unease to settlement systems.

In our view, save as mentioned above, the rules do not need to be amended. It is possible that the provision of financial collateral or additional financial collateral to take account of changes in the value of the financial collateral or in the amount of the relevant financial obligation could give rise to a preference, but adequate protection in deserving cases is provided by Section 241(2) of the 1986 Act.

If our views were accepted, we would wish the implementing legislation to make it clear (and certainly in much clearer terms than in the Directive) that nothing in the legislation affects the operation of Sections 238, 239, 242, 243, 244 and 423 of the 1986 Act. This is, of course, the contrary position to that taken in relation to market contracts by section 165 of the Companies Act 1989.

Incidentally, the wording of Article 8.3(b) is defective in that it should give the right to substitute financial collateral with a value "not less than" that substituted.

Article 9 – Choice of law and the Hague

Ideally, the Directive would be implemented simultaneously and as part of the same measure as the Hague Convention. However, given the timetable for implementing the Directive[56], it is understood that this is not practicable.

The paper recognises that Article 9 may need to be adapted to take account of the Hague Convention. Article 4 of the Hague Convention provides that the governing law shall be the law in force in the state expressly agreed in the account agreement or, if the account agreement expressly provides that another law is applicable, that other law, subject in each case to the "reality test". Article 9 of the Directive states that any question shall be determined by the law of the country in which the relevant account is maintained. There is clearly an inconsistency between the two provisions and we understand that steps are being taken to amend the Directive to bring it into line with the Convention.[57]

There is also a need to bring Article 9 of the Settlement Finality Directive into line with the Hague Convention.

Other points

There does not appear to be a definition in the Directive of "financial collateral", although it is implicit (see paragraph (3) of the preamble) that the expression includes both securities and cash. As this is fundamental to the working of the Directive, we would like to see a definition appear in the implementing legislation. It could perhaps be defined as "any financial instrument or cash".

The preamble[58] states that the Directive does not address rights which any person may have in respect of assets provided as financial collateral, and which arise otherwise than under the

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[56] The Directive is required to be implemented no later than 27 December 2003 (18 months after publication in the EU's Official Journal).

[57] We understand that the European Commission – DG Markt is currently drafting two proposals for council decisions which allow the signature and ratification of the Hague Convention. Once the first decision has been adopted, and the Convention has been signed by the European Community, the Commission will present a proposal for a directive to modify the Collateral and the Settlement Finality Directives. This is likely to go through a fast-track procedure in the European Parliament and Council. It is understood that Member States are likely to wait for these amendments to be adopted before implementing in full the Collateral Directive.

[58] Paragraph (6).

terms of the financial collateral arrangement. Examples given of such rights are rights of restitution arising from mistake, error or lack of capacity. It would be helpful if the implementing legislation could state in express terms that such other rights are not addressed, including, for example, the right to trace into the hands of a person who dishonestly assists in, or who knowingly receives assets as a result of, a breach of trust.

We consider that it would be desirable to specify in the implementing legislation which particular winding-up proceedings and reorganisation measures exist under English law, rather as has been done with the Insolvency Proceedings Regulation[59]. The definitions in Articles 2.1(j) and 2.1(k) do not always provide a clear answer. We have already questioned[60] whether the filing of a notice of appointment of an administrator under the 2002 Act amounts to "intervention" by judicial authorities. Equally, it is by no means clear that the confirmation given under Rule 7.62 of the Rules constitutes "intervention" so as to render a creditors' voluntary winding-up "winding-up proceedings" within the meaning of the Directive. A schedule specifying the "winding-up proceedings" and the "reorganisation measures" that exist under English law would avoid any doubt on this score.

It is assumed that a members' voluntary winding-up will not constitute "winding-up proceedings" for the purposes of the Directive.[61]

Even if Article 1.2(e) is implemented, it will still be necessary to address ambiguities in Article 1.2(d). One example is that the wording of Article 1.2(d) is inadequate to cover securitisations fully. Whilst the wording attempts to deal with securitisations, it may not cover the situation where security is provided to the issuer itself to secure an onward loan made by it out of the issue proceeds to the originator, as happens, for instance, in a whole business securitisation, nor will it necessarily cover the situation where the issuer raises finance by issuing commercial paper and has a standby liquidity facility from a group of banks on which the issuer can fall back if it needs additional funding to redeem its commercial paper at maturity. We recommend that the Directive should be implemented in sufficiently wide terms that any person who provides or takes collateral as part of a capital market arrangement within the meaning of new Section 72B of the Insolvency Act 1986 (as inserted by Section 250 of the Enterprise Act 2002) is covered. In addition, it would be helpful to clarify that a clearing house recognised under Part VII of the Companies Act 1989 comes within the definition of a "clearing house" for Article 1.2(d) purposes, whether or not it is also the operator of a designated system under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999.

We would wish the definition of "financial instruments" in the implementing legislation to be as wide as possible, but also to create an element of flexibility so that as new techniques are developed they may readily be encompassed by the definition.

One way of doing this might be to incorporate the definitions included in the relevant paragraphs of Part III of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the "RAO") as amended from time to time, and then to include as a residual category any other financial instruments containing the definition in the Directive (Article 2.1(e)). In that way, the definition in the Directive would automatically change whenever

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[59] See the EC Regulation on Insolvency Proceedings 2000, Council Regulation (EC) No. 1346/2000 of 29 May 2000, Annexes A and B.
[60] See Articles 4 and 7 – Administration, supra.
[61] The inclusion of a creditors' voluntary winding-up, and the exclusion of a members' voluntary winding-up, would be consistent with Article 2(a) and Annex A of the Insolvency Proceedings Regulation.

there was a change in the description of the relevant specified investments in Part III of the RAO.

Incidentally, the definition appearing in Article 2.1(e) of the Directive refers to "debt instruments if these are negotiable in the capital market". The word "negotiable" has a special meaning under English law, and we would think that if the definition in the directive is to be used in the implementing legislation (whether as a residual category or otherwise), it would be preferable to use the word "tradeable", or something similar.

2 May 2003

APPENDIX

Directive on Financial Collateral Arrangements: Initial policy and legal questions

Introduction

1. This note aims to help orientation on the major policy and legal questions raised by the Directive.

2. The position set out in the note is for comment and discussion only, and — except as noted in paragraph 4 below — does not represent Government policy.

3. We would be grateful for comments by 30 April 2003 in response to both the direct questions and the assertions set out here. We would also be grateful for any other comments recipients may have on the implementation of the Directive.

Overall approach

4. The UK identified[1] the Directive as one of its ten priority Financial Services Action Plan (FSAP) measures. In an Explanatory Memorandum to Parliament[2] the Economic Secretary to the Treasury noted that the Directive:

> 'will help complete the single capital market. The Government is therefore keen to see the Directive adopted as quickly as possible and that it meets the objective of reducing the cost of capital in the EU. Reducing the cost of capital will, in turn, improve the EU's competitiveness, including that of the UK."

5. The adoption of the Directive was a welcome development which by providing additional and reliable means of financing across the EU will help both investors and those seeking finance. This will reduce the cost of capital, contributing to greater prosperity in the EU.

6. It is therefore proposed that the overall approach in implementing the Directive will be to:

    (Aim)

    a. Extend the scope and usefulness of financial collateral arrangements as widely as possible...

    b. . . . having regard to general UK policy on insolvency.

    (Method)

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[1] *Completing a Dynamic Single European Financial Services Market: A Catalyst for Economic Prosperity for Citizens and Business across the EU*, HM Treasury, July 2000.
[2] EM of 5 May 2001 on the Commission's proposal for the Directive.

c. Provide a clear, helpful and effective legal framework, but avoid rewriting law needlessly (recognising that the law in the UK already reflects many of the Directive's provisions).

7. Have you any comments on this approach?

Article 1— persons within scope of implementation

8. Article 1, amongst other matters of scope, defines which persons are within the scope of the Directive. The Directive only applies to financial collateral arrangements[3] (FCAs) which are between parties as specified in Article 1(2).

9. Broadly, Article 1 (2)(a) to (d) includes financial institutions, while Article 1 (2)(e) includes other persons (ie corporates but not natural persons). Using these phrases as (slightly simplistic) short-hand, the Directive therefore extends to FCAs between two financial institutions or between a financial institution and a corporate.

10. Under Article 1(3), there is a discretion to exclude corporates from the scope of the implementation. Exercise of that discretion would, clearly be contrary to both our overall policy objective and to the broad current position in UK law (ie where many of the Directive's provisions already apply irrespective of the identity/capacity of the parties).

11. Moreover, if feasible under our implementing powers, the same considerations imply that we should extend the scope of the implementation to cover all FCAs between two corporates, as well as between two financial institutions. This would:

a. be consistent with our overall policy objectives;

b. considerably simplify implementation by avoiding the need for reproducing in UK law the elaborate definitions of Article 1 (2)(c) in particular; and

c. make the law clearer, simpler and more consistent.

12. It would be consistent with the overall approach, and particularly paragraph 6.a above, to go further and apply the same principles to all FCAs, including those involving *individual natural persons* (whether in a personal/non-business capacity or that of a sole trader). Our initial view is that this is unlikely to be legally feasible using the implementing powers in the European Communities Act 1972. However, it would be helpful to know whether there would be significant benefits in practice were we able to go this far. Doing so would raise various questions. Those which immediately occur to us are:

a. what sort of situations would then be covered? The most common appears to be where an individual's bank account is used as collateral for a personal or business loan, or guarantee;

b. what would be the advantages and disadvantages of this further extension?

c. would you support such an extension?

[3] See Article 2(1)(a).

Article 1— collateral within scope of implementation

13. Article 1(4)(b) provides a further opt-out for Member States:

> Member States may exclude from the scope of this Directive financial collateral consisting of the collateral provider's own shares, shares in affiliated undertakings within the meaning of seventh Council Directive 83/349/EEC of 13 June 1983 on consolidated accounts, and shares in undertakings whose exclusive purpose is to own means of production that are essential for the collateral provider's business or to own real property.

14. We do not see any need to exercise this opt-out. We understand this provision was introduced solely to prevent the unintended application of the Directive to real property under certain Scandinavian mortgage practices.

Article 3— formal requirements

15. The only UK legislation we are currently aware of that would or might need to be disapplied from FCAs within the scope of the Directive is Part XII of the Companies Act 1985 concerning the registration of charges granted by companies. The provisions of that Part relate only to certain types of charge and charges over certain types of property, but they could apply to some FCAs[4] — for example, where a floating charge is granted covering various assets of the company including cash and/or securities, or where a charge is granted over book debts.

16. If the same principles were to be extended to FCAs involving individuals, as canvassed in paragraph 12 above, we would have to consider disapplying the individual registration provisions in the Bills of Sale Act 1878, and Bills of Sale Act (1878) Amendment Act 1882. These provide for formalities and registration of bills of sale granted as security[5] by *individuals*. Although the Acts only apply in respect of personal chattels — and this may not include financial collateral within the meaning of the Directive, which covers only cash and financial instruments as defined in Article 2(1)(d) & (e) — section 344 of the Insolvency Act 1986 extended the registration provisions to include book debts in certain cases.

17. Are there any other registration or procedural formalities which would, or might, need to be disapplied?

Article 4— enforcement by appropriation

18. Generally in UK law, enforcement of security FCAs[6] occurs by sale or disposal of the assets concerned. An alternative route is appropriation, where in return for the secured debt being extinguished, the absolute ownership of the assets is transferred to the collateral taker.

19. There is obviously a risk that the collateral taker will seek to value the collateral at an unrealistically low level, thus reducing the return of any surplus value to the collateral provider (ie to the detriment of the collateral provider and its other creditors). For this

[4] This consideration only applies to security FCAs as defined in Article 2(1)(c).
[5] Again, this consideration only applies to security FCAs as defined in Article 2(l)(c).
[6] See Article 2(1)(c).

reason, we believe that appropriation is currently only possible in the UK if a court order is first obtained — do you agree with that analysis of the current law?

20. Article 4(4)(b) means that this requirement for a court order will have to be removed. To mitigate the risk identified in paragraph 19, it is proposed that, as allowed by Article 4(6), UK law will include a requirement that any valuation of the collateral and the calculation of relevant financial obligations must be conducted in a commercially reasonable manner.

Articles 4 and 7— administration

21. Article 4(5) says that:

> Member States shall ensure that a financial collateral arrangement can take effect in accordance with its terms notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures[7] in respect of the collateral provider or collateral taker.

22. Article 7(1) says that:

> Member States shall ensure that a close-out netting provision can take effect in accordance with its terms ... notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of the collateral provider and/or the collateral taker.

23. These provisions mean that the statutory bar on the enforcement of security when a company is in administration[8] will need to be disapplied in the case of a security FCA. Do we need to do anything further to ensure that administration (and other relevant insolvency-related procedures) do not cut across these provisions[9]? Even if not, would it help to make this clear explicitly?

Article 5—right of use

24. Article 5(1) requires the recognition of the collateral taker's ability to use for its own purposes financial collateral provided under a security FCA, where this has been agreed by the collateral provider. Although this is arguably already the case under UK law, would it be helpful to spell this out explicitly?

Article 6— no recharacterisation

25. Article 6(1) prevents title transfer FCAs[10] being recharacterised by a court as security FCAs. Although such a recharacterisation risk is quite limited under UK law, we consider that this should be spelt out explicitly — do you agree?

[7] The terms "winding-up proceedings" and "reorganisation measures" are defined in Article 2(1)(j) & (k) and cover various, but not all, types of insolvency-related procedures in the UK.
[8] Section l0(l)(b) of the Insolvency Act 1986 in England and Wales, (which will be superseded by paragraph 43 of Schedule B1 to that Act, as inserted by Schedule 16 to the Enterprise Act 2002.
[9] An example might be certain restrictions on rights of set-off that apply to Insurance Companies which have gone into administration under article 5 (mutual credit and set-off) of the Financial Services and Markets Act 2000 (Administration Orders relating to Insurers) Order 2002.
[10] See Article 2.1(b).

Article 7— recognition of close-out netting provisions

26. Article 7(1)(a) requires the recognition of close-out netting provisions notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures. Although UK law is generally very favourable to the operation of such provisions, there may be restrictions in certain areas that require to be disapplied in the case of title transfer FCAs[11] and security FCAs which also involve the use of set-off in certain cases[12].

27. To give effect to Article 7(1)(b) we will need to ensure that a close-out netting provision cannot be undermined by any purported assignment, judicial or other attachment or other disposition of or in respect of such rights. Are you aware of any other circumstances which may need to be covered, or specific legal rules which may need to be disapplied, in the context of FCAs in order to give effect to Article 7(1)(b)?

28. Is there anything you consider we need to do to implement Article 7(2)? So far as we are aware, nothing in UK law imposes any requirements of the sort listed in Article 4(4) as mandatory conditions for the exercise of close-out netting?

Article 8

29. Article 8 requires the disapplication in relation to FCAs of insolvency-related provisions that have the effect of automatically rendering invalid or void, or that allow a court to declare invalid or void or to reverse, any FCA entered or any transfer of property made under a FCA prior to the onset of winding-up proceedings or reorganisation measures. An obvious example under UK law is section 127 of the Insolvency Act 1986.

30. There are also further provisions relating to the effectiveness of collateral top-up and substitution in relation to a FCA, which we believe are not problematic under existing UK law, although again it might be helpful to spell this out explicitly.

Article 9— choice of law and the Hague

31. As acknowledged as a possibility on adoption of the Directive, this Article may need to be adapted to take into account the finalisation of the Hague Convention[13]. We will consider this Article further as more becomes apparent on the Commission's approach to implementing the Convention in respect of EC law.

HM Treasury
April 2003

[11] See footnote 9 above.
[12] Such as where a security FCA includes cash and/or has involved the exercise of a right of use in respect of securities.
[13] Hague Convention (36) on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary.