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7 April 2011

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Dear David

**Implementation of EU Directive 2009/44/EC on settlement finality and financial collateral arrangements**

You may recall that, on 3 November 2010, the Financial Markets Law Committee (the "FMLC") submitted a response to HM Treasury's consultation on the implementation of Directive 2009/44/EC on settlement finality and financial collateral arrangements. The letter (attached) responded affirmatively to question 6 of the consultation ("Do you consider that floating charges which are "collateral security charges" within the meaning of the 1999 Regulations should be brought within the scope of the 2003 Regulations?") and noted that HM Treasury could reduce uncertainty as to which floating charges fall within the safe harbour from the registration requirements under section 395 of the Companies Act 1985 (now section 860 of the Companies Act 2006) by including comparable charges (market charges within the meaning of Part VII of the Companies Act 1989 and system charges within the meaning of the Financial Markets and Insolvency Regulations 1996) within the scope of paragraph 4(4) of the Financial Collateral Arrangements (No. 2) Regulations 2003 (the "2003 Regulations"). Moreover, the letter detailed the widespread legal uncertainty voiced by market participants as to whether or not collateral security charges (particularly floating charges over financial collateral given to clearing systems, central banks, settlement banks, and to payment and settlement systems) are actually protected by paragraph 4(4) of the 2003 Regulations.

By way of brief reminder, this uncertainty arises from the definition of "security financial collateral arrangements" in paragraph 4(4) of the 2003 Regulations which expressly includes floating charges but also requires the collateral subject to the charge to be delivered,

transferred, held, registered or otherwise designated so that it is in the possession or control of the collateral-taker. As you will be aware, there are a number of reasons why the concepts of possession and control do not sit comfortably with the nature of collateral security charges. The essence of a floating charge (as opposed to a fixed charge) is that it permits a collateral-provider to remain free to deal with a "circulating and ambulatory" pool of assets.[1] Furthermore, in *Gray and others v G-T-P Group Ltd Re F2G Realisations (in liquidation)*,[2] Mr Justice Vos suggested that an English law concept of possession of intangible property may not exist, citing Beale, Bridge, Gullifer and Lomnika on *The Law of Personal Property Security* (2007). Mr Justice Vos held that a collateral-taker needs the legal right to deal with charged assets in order to satisfy the control test for the purpose of the 2003 Regulations. As charged assets fluctuate as the securities are traded, it is difficult to see how members of clearing systems or participants in payment and settlement systems could give up legal control of the charged assets on a day-to-day basis and simultaneously continue to trade in them. The decision in *Gray* has led many participants in these systems to doubt whether collateral security charges can ever fall within the exemption from registration in the 2003 Regulations, notwithstanding the express inclusion of floating charges in paragraph 4(4).

In the letter dated 3 November 2010, the FMLC proposed a number of suggestions for removing the uncertainty:

(i) removing floating charges from the categories of charges potentially protected by paragraph 4(4) of the 2003 Regulations and inserting a separate provision that expressly exempts floating charges from registration requirements under section 395 of the Companies Act 1985 (now section 860 of the Companies Act 2006);

(ii) inserting a definition of "possession" into amending Regulations to clarify that possession of financial intangibles could be demonstrated by the collateral being credited to an account in the name of the collateral-taker or a person acting on his behalf;

(iii) adopting a clearer but less strict test for "control" to qualify the inclusion of floating charges in the 2003 Regulations, such as by recognising "negative control" (as discussed in *Gray*) or "practical control" as sufficient to establish control; or

(iv) inserting an exemption from registration under the Companies Act 2006 for floating charges over financial collateral.

The Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations 2010 (the "2010 Regulations"), published in December 2010, seek to remove the uncertainty described above by inserting a definition of "possession" into the 2010 Regulations, as opposed to amending the control test or inserting an express exemption in the 2010 Regulations. The FMLC is concerned that this step may not

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1 *National Westminister Bank v Spectrum Plus and others* [2005] UKHL 41

2 [2010] EWHC 1772 (Ch)

provide a sufficient remedy to the legal uncertainty as to whether collateral security charges can satisfy the possession and control tests in the definition of "security financial collateral arrangements" for reasons explained below.

In order for two parties (party A and party B) to enter into an over-the-counter ("OTC") transaction to be cleared by a clearing house, each party must either (i) be a member of the relevant clearing house (member A and member B) or (ii) (if it is not capable of becoming, or does not wish to become, a member of the clearing house) appoint a member of the clearing house to clear transactions on its behalf (thereby becoming a client (client A or client B) of a clearing house member). Whilst a number of entities (especially large financial institutions) are capable of becoming clearing house members, and therefore will be able to use the first option described above, a significant number of entities (e.g. corporate entities who do not enter into large volumes of OTC derivatives) will favour, or be obliged to use, the second option.

One of the obligations to which clearing house members are subject when clearing derivative transactions through a clearing house is the obligation to post margin with the clearing house. Under the second option (i.e. client A and client B using member A and member B, respectively, to clear their derivative transaction through a clearing house), each client posts margin with the relevant member, which then posts the margin with the clearing house. As each client is exposed to default by the member, the member will grant a security interest (which may be expressed as a fixed charge but might be recharacterised as a floating equitable charge) over the assets posted with the clearing house in favour of its client. The charge will crystallise in the event of a default by the relevant member, allowing the client to divert the margin away. The clearing house requires the charged assets to be posted with a third party custodian to an account in the clearing house's name. As the margin is posted to an account in the clearing house's name, neither the client nor the member[3] (i.e. for the purposes of the 2010 Regulations, neither the collateral-taker nor the collateral-provider) can be in "possession" of the charged assets as defined by paragraph 4(2)(c) of the 2010 Regulations, to fall within the exemption from registration provided by paragraph 4(4) of the 2003 Regulations. This means that floating charges of this kind can only be protected by the safe harbour in the 2003 Regulations if and in so far as they satisfy the "control" test. Therefore it seems to the FMLC that providing a definition of "possession" does not go all the way to implement a policy of protecting collateral security charges from registration requirements, especially in light of the proposed European Market Infrastructure Regulation which, by imposing an obligation to clear all eligible OTC derivatives, is likely to increase the number of entities using the structure described above. The current 2010 Regulations have not obviated the need for a definition of "control" and the FMLC hopes that, having determined to implement a policy to protect collateral security charges, HM Government will seriously consider whether legal uncertainty has been created in this regard.

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[3] Although the client is the original provider of margin, it is with respect to the charge, the party with the benefit of the security i.e. the collateral-taker.

Certainty of the formality requirements and enforcement procedures in the 2003 Regulations is necessary because Directive 2002/47/EC on financial collateral arrangements demands financial stability. Moreover, the stakes of systemic risk are high: £1,442bn worth of securities moved through CREST on a daily basis in March 2010. The transactions involving clearing houses described above rely on central securities depositories such as CREST to provide the necessary payment and settlement arrangements to enable these transactions to occur. The settlement banks which then provide liquidity to CREST members to facilitate settlement can thus be seen to have very large exposures to counterparty risk from floating charges. Whilst it is not within the remit of the FMLC to comment on matters of policy, it is plain that any doubts about the enforceability of the collateral arrangements will put the UK clearing house at a competitive disadvantage to its overseas rivals.

In view of the above, the FMLC considers that legal certainty could be achieved by inserting a definition of "control" into the 2003 Regulations by way of further amending Regulations. Whilst the FMLC does not seek to comment on policy, the Committee considers that the legal uncertainty surrounding "control" could be ameliorated by the recognition of "negative control" or "practical control" (as outlined in the FMLC's letter dated 3 November 2010, attached). Negative control could be evidenced by contractual agreement between the collateral-provider and the collateral-taker that the collateral-provider will not dispose of, create further security over, or otherwise deal with the charged assets without the collateral-taker's consent (subject to the right to substitute financial collateral or withdraw excess financial collateral). Practical control could be evidenced by the collateral-taker being entitled to prohibit the collateral-provider from dealing with the financial collateral and by being required expressly to authorise the collateral-provider to deal in the secured assets above an agreed threshold. Similarly, the right of collateral-providers to substitute collateral on terms whereby the collateral-provider has no ability to prevent the substitute assets from becoming subject to the collateral-taker's security at the time the substitution is made should not infringe the notion of control for the purposes of the 2003 Regulations. The FMLC has further suggestions to make in this regard and would very much appreciate the chance to discuss these with you.

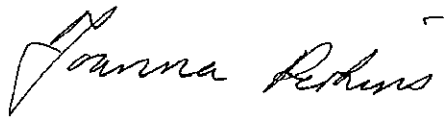
If HM Treasury considers that an exemption for all floating charges from registration requirements would be too wide, the legal uncertainty discussed above could be remedied by a provision in further amending Regulations expressly exempting the following from the control and possession tests:

(i) floating charges which include assets held by, or claims against, a recognised investment exchange or a recognised clearing house (or settlement system within the scope of Directive 98/26/EC on settlement finality in payment and securities settlement systems); or,

(ii) charges created for the purpose of enabling the rights and liabilities of the clearing member under transactions in investments to be settled in contracts entered into by a clearing house with a member of that clearing house.

I would be very happy to discuss the above matters with you further, particularly the comments made about a definition of "control". Please do not hesitate to contact me if you would like to do so.

Yours sincerely



Joanna Perkins[4]
**FMLC Director**

Enc: FMLC letter of 3 November 2010

Cc: Nick Howard of the Insolvency Service

[4] The FMLC is grateful to Simon Firth and Tony Anderson for their assistance with preparing this letter.

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3 November 2010

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Dear Sirs

## A consultation on the implementation of EU Directive 2009/44/EC (the "Amending Directive") on settlement finality and financial collateral arrangements (the "Consultation")

As you are aware, the remit of the Financial Markets Law Committee (the "FMLC") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

Some of the questions asked in the Consultation raise issues of policy as well as of law. The FMLC has confined its response to those questions raising issues of legal uncertainty which may have an impact upon the financial markets.

**Question 3. Do you have any comments on draft regulation 4 of the amending SI?**

*Amendment of Scottish law on floating charges*

The FMLC agrees that the requirement for Scottish floating charges which are security financial collateral arrangements to be registered in the Scottish Register of Floating Charges would be inconsistent with Recitals 9 and 10 of Directive 2002/47/EC on financial collateral arrangements (the "Directive"), preventing Member States from imposing perfection requirements on financial collateral arrangements. The FMLC therefore supports the proposed amendment.

*Extension of the 2003 Regulations to "credit claims"*

One of the objectives of the Directive was to eliminate all formalities for the perfection[1] of financial collateral arrangements. However, with the extension of the Directive (and the Financial Collateral Arrangements Regulations (No 2) 2003 (the "2003 Regulations")) to "credit claims", a formality will remain under English law for the perfection of an assignment of such claims, unless the 2003 Regulations are amended to disapply this requirement.

[1] Within the meaning of the Directive, see Recital 9.

In order to achieve a legal assignment of credit claims, section 136 Law of Property Act 1925 (the "LPA") must be complied with. This requires (i) the assignment to be by way of a signed instrument; and (ii) notice to be served on the third party obligor. Delivering the notice of assignment perfects the transfer of legal title to the assignee, meaning that the obligor must pay the assignee and that it may not discharge its debt by paying the assignor. Delivery of the notice also establishes the assignee's right to payment in priority to any purported transferees of the assignor's interests. Regulation 4(3) of the 2003 Regulations already disapplies the requirement for a signed instrument in relation to financial collateral arrangements. However, as the draft Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations 2010 are currently drafted, the requirement for written notice to be served on the borrower remains. This would mean that an assignment of a credit claim under English law pursuant to a financial collateral arrangement would still be required to be notified to the borrower and any relevant guarantor, if any (as to which, see below).

This requirement for notification appears to be inconsistent with Recitals 9 and 10 of the Directive, which broadly prevent Member States' legal systems from imposing perfection requirements on financial collateral arrangements, other than the requirement for possession or control.

The FMLC therefore suggests that, in order to comply with the Directive, the 2003 Regulations should be amended in order to disapply section 136 LPA in its entirety as it applies to financial collateral arrangements over credit claims, provided that the relevant collateral is under the control of the collateral-taker or of a person acting on the collateral-taker's behalf, including any clearing system through which a credit claim is held. Similarly, on termination of the financial collateral arrangement, no notice should be required to re-assign the credit claim if the financial collateral is under the control of the collateral giver (or a person acting on its behalf, including any clearing system through which a credit claim is held). The FMLC considers that it would be helpful if it could be made clear that in these circumstances, control of a credit claim should relate to both the title to the credit claim and to moneys paid by the debtor under the credit claim.

The FMLC considers that removal of the requirement for notice to be served on the borrower would be consistent with Recitals 9 and 10 of the Directive and would avoid uncertainty as to a possible discrepancy between the Directive's aim to restrict perfection requirements and section 136 LPA.

*Ancillary rights and claims*

Credit claims (or loans) by their nature may be linked by their terms to a variety of ancillary rights, claims and obligations, which must also be transferred with the credit claim to the collateral taker. Such ancillary rights and claims typically include security, sureties and guarantees and intercreditor arrangements and may be subject to additional formalities. For example, in the case of guarantees, a transfer of a credit claim without the express consent of a guarantor may in some circumstances operate to discharge the guarantor from its guarantee at common law.

The FMLC therefore suggests that consideration should be given to the formalities applicable not just to credit claims themselves but also to the rights and claims attaching to them. In particular, the FMLC suggests consideration should be given to extending the protection of the 2003 Regulations to rights and claims which secure or guarantee a credit claim. We would be very happy to discuss this suggestion further with you.

**Question 6. Do you consider that floating charges which are "collateral security charges" within the meaning of the 1999 Regulations should be brought within the scope of the 2003 Regulations?**

The FMLC considers that there is widespread uncertainty about whether or not floating charges over financial collateral (including collateral security charges) currently fall within the definition of "security financial collateral arrangements" in the 2003 Regulations, with the effect that it is unclear whether or not the protections afforded by the 2003 Regulations apply. Such charges are therefore typically registered at Companies House, "just in case" they are outside the scope of the 2003 Regulations.

As noted in the Consultation, the uncertainty chiefly arises from the definition of "security financial collateral arrangement" in Regulation 3. The definition expressly includes floating charges in the categories of charges which can constitute a security financial collateral arrangement. However, the definition then goes on to require that the collateral subject to a floating charge must be delivered, transferred, held, registered or otherwise designated so as to be in the **possession** or under the **control** of the collateral-taker. The essence of a floating charge, however, is that the collateral-provider remains free to deal with the "circulating and ambulatory" pool of charged assets.[2]

Although the definition of security financial collateral arrangement does allow the collateral provider to substitute equivalent or withdraw excess collateral, many market participants doubt whether the requirement for possession or control is nonetheless wide enough to encompass a floating charge. This has been exacerbated by the recent case of *Gray and others v G-T-P Group Ltd Re F2G Realisations Ltd (in liquidation)*[3], in which the concepts of possession and control were considered.

There was little discussion of the requirement of "possession", although the court did cite Beale, Bridge, Gullifer and Lomnicka on the Law of Personal Property Security 2007, which suggests that there is no English law concept of possession of intangible property.

In relation to control, it was held that administrative or practical control of the charged assets was not sufficient: the collateral taker must have the legal right to deal with the collateral.

The FMLC is aware that, following *Gray*, there are differing views in the market as to whether any floating charges over financial collateral can ever fall within the protection of the 2003 Regulations. Certainly, although the court in *Gray* left open the possibility that such a charge might exist, none were specifically identified. On this basis, the FMLC understands, it is common for floating charges over financial collateral to be registered at Companies House.

*An exemption for collateral security charges?*

In the case of charges (typically floating charges) over financial collateral given to clearing systems and central banks (that is, "collateral security charges"), the collateral taker may not have legal control of the charged assets in the strict *Gray* or *Spectrum Plus* sense. Indeed, it is hard to see how clearing system members could give up legal control of the assets subject to the charge on a day to day basis and at the same time continue to trade in them: the assets subject to the charge must necessarily fluctuate as securities are, for example, bought and sold.

Conversely, it appears that these are the type of charges that the Directive was intended to apply to. The Directive was intended to restrict the formality requirements imposed on security arrangements over financial collateral in order to, amongst other things, enhance the stability of the financial system. As noted in the Consultation, collateral security charges support daily transactions valued in billions of pounds between CREST and its members. The FMLC submits that it is detrimental to financial stability if the formality requirements and enforcement procedures applicable to such charges are uncertain. These charges have also

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[2] *National Westminster Bank v Spectrum Plus and others* [2005] UKHL 41

[3] [2010] All ER (D) 80 (May)

been given certain protections on insolvency under other legislative provisions, for example Regulation 18 of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999.[4]

The FMLC considers that the uncertainty as to whether collateral security charges fall within the scope of the 2003 Regulations should be removed. Although commenting on policy issues is outside the FMLC's remit, the FMLC suggests that it would be consistent with the cited objectives of the Directive to provide that collateral security charges are within the scope of the 2003 Regulations. The FMLC therefore supports bringing collateral security charges within the scope of the 2003 Regulations.

*Comparable charges to collateral security charges*

Collateral security charges are not the only floating charges which support the infrastructure of the financial markets, In particular, "market charges" within the meaning of Part VII of the Companies Act 1989 (including "system charges" within the meaning of the Financial Markets and Insolvency Regulations 1996) perform similar functions and have also been afforded insolvency protections under other legislation protecting the infrastructure of the financial markets in the UK.[5] The FMLC therefore considers that, if collateral security charges are exempted from registration, the exemption should also be extended to market charges and system charges.

*A wider exemption?*

The FMLC notes that bringing collateral security charges and comparable charges within the protection of the 2003 Regulations could be achieved either by amending the 2003 Regulations to expressly refer to collateral security charges, or by legislating to exempt floating charges over financial collateral from registration more generally (for example, pursuant to the power in section 255 Banking Act 2009).[6] Collateral security charges are only a subset of floating charges over financial collateral which are widely used in the financial markets to secure lending.

The FMLC submits that consideration should be given to clarifying whether floating charges can exhibit sufficient control in order to fall within the definition of "security financial collateral arrangement". Although the *Gray* case suggests that floating charges cannot fall within the definition, the FMLC considers that uncertainty on this question is likely to persist. (Market participants are likely to question why floating charges were included in the 2003 Regulations at all, if they were not intended to benefit from their protections, at least in some circumstances).

In the FMLC's view, it would be desirable to remove this uncertainty, and there are several ways of doing so.

(i) The uncertainty could be resolved by removing floating charges from the categories of charges potentially protected, although for the reasons given above, this does not appear to be consistent with the Directive's aims.

(ii) Alternatively, some clarification of the meaning of "possession" could be given. Although the *Gray* case suggests that possession is not relevant in relation to security over financial intangibles, this begs the question of why it was included in the Regulations at all. If it were clear that possession of financial intangibles could be

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[4] SI 199912979

[5] See, for example section 72F Insolvency Act 1985

[6] Indeed, the FMLC suggests that this provision may provide a sounder basis for all of the amendments discussed in this paper. To the extent that any of the amendments discussed herein might go beyond those required to ensure compliance with the Amending Directive, section 255 Banking Act 2009 would provide a clear power to adopt them, whereas adopting changes section 2(2) European Communities Act 1972 may give rise to challenges on the grounds of *vires*.

demonstrated, say, by the collateral being credited to an account in the name of the collateral-taker or a person acting on his behalf, this would give some meaning to the concept of possession in the context of financial intangibles. We suggest that this could be achieved by the insertion of a definition of possession in the 2003 Regulations, as follows:

*"possession" includes the case where financial collateral has been credited to an account, register of title or equivalent in the name of the collateral-taker or a person acting on his behalf."*

We suggest that further clarity could be achieved by inserting additional wording to address the situation where the collateral-taker is itself an account-provider (such as a custodian) and has provided an account to its client to which the financial collateral is credited, as follows:

*"(whether or not the collateral-taker, or person acting on his behalf, has credited the financial collateral to an account, register of title or equivalent in the name of the collateral-provider on his, or that person's books)".*

(iii) A clearer but less strict test for "control" would also give some meaning to the inclusion of floating charges in the 2003 Regulations. For example, a recognition that "negative control", as discussed in *Gray*, or "practical control" would suffice to establish control would create more certainty. Negative control could be evidenced by contractual agreement between the collateral-provider and the collateral-taker that the collateral-provider will not dispose of, create further security over or otherwise deal with the assets subject to the charge without the collateral-taker's consent (subject to the right to substitute/withdraw excess collateral). Practical control could be evidenced by the ability of the collateral-taker to prevent any dealing with the collateral by the collateral-provider (whether or not in doing so it would be in breach of its contractual obligations to the collateral-provider (or any other person) and would expressly permit the collateral-provider to deal in the secured assets above an agreed threshold (as is commonly the case on prime brokerage arrangements). Similarly, rights of collateral-providers to substitute collateral on terms whereby the collateral-provider has no ability to prevent the substitute assets from becoming subject to the collateral-taker's security at the time the substitution is made should not infringe the notion of control for the purposes of the 2003 Regulations.

(iv) An exemption from registration under the Companies Act 2006 for floating charges over financial collateral (such as the one mooted in BIS's recent consultation on the registration of company charges) would also remove the uncertainty in respect of registration requirements.

The question of whether the clarity that would arise from creating a clear exclusion for such charges would be outweighed by the lack of visibility that would result is a policy question on which the FMLC does not express a view. The FMLC is aware however that other respondents to the Consultation may suggest an exemption for floating charges over financial collateral in a "wholesale" context: the FMLC is chiefly concerned with matters impacting on the wholesale financial markets and would therefore be content for any exemption only to apply to wholesale transactions.

We would be very happy to discuss any of the above comments with you further. Please do not hesitate to contact me if you would like to do so.

Yours sincerely

Joanna Perkins
FMLC Director