JULY 2008

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 132 – ALFA TELECOM TURKEY LTD v CUKUROVA FINANCE INTERNATIONAL LTD AND CUKUROVA HOLDINGS AS

Legal assessment of an issue raised in the above case, namely the extent to which the Financial Collateral Arrangements (No. 2) Regulations 2003 are ultra vires the European Communities Act 1972

c/o Bank of England
Threadneedle Street
London EC2R 8AH
www.fmlc.org

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 132 WORKING GROUP[1]

Dr Joanna Benjamin	London School of Economics / Freshfields
Stuart Isaacs QC	3 - 4 South Square Chambers
Gabriel Moss QC	3 - 4 South Square Chambers
Habib Motani	Clifford Chance LLP
Ed Murray	Allen & Overy LLP
Dermot Turing	Clifford Chance LLP
Joanna Perkins	Secretary, FMLC
Karen Hutchinson	Legal Assistant, FMLC
Saima Hanif	Legal Assistant, FMLC

[1] Thanks also go to Jenny Marshall and Nick Herrod of Allen & Overy LLP, for their assistance with this paper.

CONTENTS

1. Introduction and Executive Summary

Introduction

1.1 The role of the Financial Markets Law Committee ("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.

1.2 A recent High Court decision in the British Virgin Islands, *Alfa Telecom Turkey Ltd v Cukurova Finance International Ltd and Cukurova Holdings AS* (hereafter '*Alfa Telecom*') raised for the first time – but did not decide – the important question of the validity of the Financial Collateral Arrangements (No. 2) Regulations 2003 (SI 2003 No. 3226) ("the Regulations").

1.3 Following the decision, the FMLC members met on the 6 December 2007, and it was agreed that the UK's implementation of the Regulations would be adopted as a formal issue. A working group was formed to consider the matter.

1.4 In *Alfa Telecom*, Joseph-Olivetti J was concerned with the trial of preliminary issues relating to whether an equitable mortgagee ("Alfa") had validly appropriated shares charged to it in accordance with the right of appropriation conferred by the charges in its favour and by the Regulations. The charges were given by Cukurova Finance International Ltd ("CFI") and its parent company, Cukurova Holdings AS ("CH"), to secure sums advanced under a loan facility granted by Alfa to CFI. The Regulations came into play because two of the charges were governed by English law, on which the court received expert evidence from Lord Millett on Alfa's behalf and Professor Ross Cranston (now Cranston J) on behalf of CFI and CH. In its judgment given on 16 November 2007, the court held that Alfa had not validly appropriated the charged shares. On 22 April 2008, however, the Eastern Caribbean Court of Appeal reversed the trial judge's decision and held that Alfa's appropriation of the charged shares was valid. It is understood that an appeal to the Privy Council on the substantive issue is being pursued.

1.5 In the course of his written evidence, Professor Cranston raised the issue whether the Regulations were *ultra vires* the European Communities Act 1972 ("the Act"). However, at first instance the court ruled that it was not open to CFI and CH to take that issue:

> *…having regard to the specific issues raised by the preliminary issues and to the manner in which they had conducted their case which was tantamount to an implied acceptance that the Regulations were valid and to the general principles which restrain a court from pronouncing on the validity of the laws of a foreign nation as encapsulated in* ***The James Sagor Case*** *[1921] 3 KB 532.* [2]

The Court of Appeal did not address that point.

1.6 The purpose of this paper is to consider the question therefore left undecided in *Alfa Telecom* whether the Regulations are valid as a matter of English law. Professor Cranston's apparent view that they are not has given rise to considerable uncertainty in the financial markets and, if correct, would create a need for retrospective legislation to validate financial collateral arrangements already entered into as well as legislation to ensure the validity of such arrangements for the future. Judicial review proceedings are currently pending in the Administrative Court in which one of the questions raised is whether the Regulations are valid. However, there is no certainty that the question will be resolved in those proceedings since they are capable of being decided on other grounds, in particular alleged delay in the making of the application for judicial review.

1.7 This paper does not address the correctness of the substantive decision in *Alfa Telecom* nor whether the trial judge was correct to have shut CFI and CH out from pursuing the question whether the Regulations are valid as a matter of English law.

Executive Summary

1.8 In summary, it is submitted that the extension to the Directive introduced by regulation 3 of the Regulations naturally arises from or else is closely related to the purpose of the Directive and, accordingly, that the Regulations were validly made under section 2(2)(b) of the Act.

---

[2] Judgment, paragraph [34].

1.9 In the light of that conclusion, it is unnecessary to consider the further question of whether, if the extension were invalidly made, it would be capable of being severed so that the Regulations were otherwise valid.

2. The Act

2.1 Section 2 of the Act is concerned with the general implementation of the EC Treaties. It says:

> *"(1) All such rights, powers, liabilities, obligations and restrictions from time to time created or arising by or under the Treaties, and all such remedies and procedures from time to time provided for by or under the Treaties, as in accordance with the Treaties are without further enactment to be given legal effect or used in the United Kingdom shall be recognised and available in law, and be enforced, allowed and followed accordingly; and the expression "enforceable Community right" and similar expressions shall be read as referring to one to which this subsection applies.*
> *(2) Subject to Schedule 2 to this Act, at any time after its passing Her Majesty may by Order in Council, and any designated Minister or department may by regulations, make provision—*
> *(a) for the purpose of implementing any Community obligation of the United Kingdom, or enabling any such obligation to be implemented, or of enabling any rights enjoyed or to be enjoyed by the United Kingdom under or by virtue of the Treaties to be exercised; or*
> *(b) for the purpose of dealing with matters arising out of or related to any such obligation or rights or the coming into force, or the operation from time to time, of subsection (1) above;*
> *and in the exercise of any statutory power or duty, including any power to give directions or to legislate by means of orders, rules, regulations or other subordinate instrument, the person entrusted with the power or duty may have regard to the objects of the Communities and to any such obligation or rights as aforesaid.*
> *In this subsection "designated Minister or department" means such Minister of the Crown or government department as may from time to time be designated by Order in Council in relation to any matter or for any purpose, but subject to such restrictions or conditions (if any) as may be specified by the Order in Council.*
> *…*
> *(4) The provision that may be made under subsection (2) above includes, subject to Schedule 2 to this Act, any such provision (of any such extent) as might be made by Act of Parliament, and any enactment passed or to be passed, other than one contained in this Part of this Act, shall be construed and have effect subject to the foregoing provisions of this section; but, except as may be provided by any Act passed after this Act, Schedule 2 shall have effect in connection with the powers conferred by this and the following sections of this Act to make Orders in Council and regulations.*

2.2 Schedule 2 to the Act contains provisions relating to subordinate legislation which are not material for present purposes.

3. The Regulations

3.1 The Regulations were made by the Treasury[3] and were expressed to be in exercise of the powers conferred on it by section 2(2) of the Act.[4] They implement Parliament and Council Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements ("the Directive"), which is intended to promote the integration and cost efficiency of the financial markets and the stability of the financial system.

3.2 Financial collateral, as that term is used in the Directive, may be in the form of cash or financial instruments or both and is provided by one party (the collateral provider) to another party (the collateral taker) to minimise the risk of financial loss to the collateral taker in the event that the collateral provider defaults on its financial obligations to the collateral taker. The Directive creates a uniform EU legal framework for domestic and cross-border financial collateral arrangements, does away with virtually all formal requirements traditionally imposed on the creation, perfection and enforcement of financial collateral arrangements in various EU member states, provides protection for financial collateral arrangements from avoidance (or the risk of avoidance) under insolvency law rules that exist in one form or another in various EU member states (such as "zero-hour" rules and rules prohibiting preferential transfers and transactions at an undervalue) and clarifies the conflict of laws rule applicable to the holding and transfer of financial collateral in the form of intermediated securities.

3.3 Under Article 1(2) of the Directive, both the collateral taker and the collateral provider must belong to one of the categories there set out. In particular, under Article 1(2)(e), a person other than a natural person (including unincorporated firms and partnerships) is included but only so long as the other party to the arrangements is an institution as defined in Article 1(2)(a) to (d). In contrast, and by way of an extension to the scope of the Directive, the definitions of "*security financial collateral arrangement*" and "*title transfer financial collateral arrangement*" in regulation 3 of the Regulations includes an agreement or arrangement evidenced in

---

[3] Being the government department designated for the purposes of section 2(2) of the Act in relation to collateral security pursuant to SI 2003/1888.

[4] See generally Lewis, *Judicial Remedies in Public Law* (2nd ed, 2000), paragraph 15-037 to 15-039).

writing where the collateral provider and the collateral taker are *both* non-natural persons.[5]

3.4 In extending the ambit of the legislation beyond the scope of the Directive, the United Kingdom is not alone amongst the EU member states. Nine other member states[6] have widened the Directive's scope to cover entities not referred to in the Directive.[7] Also, enlargement of the scope of the Directive has not been confined to its personal scope of application.[8]

3.5 To the extent that the scope of the Regulations is coextensive with the Directive, no question of the invalidity of the Regulations arises.

3.6 The question of the invalidity of the Regulations only arises insofar as the scope of the Regulations exceeds that of the Directive. In that situation, the further question would then arise whether the Regulations were partially valid to the extent that their scope was coextensive with that of the Directive.

4. *Oakley v Animal* and later cases

4.1 The leading authority on the validity of a statutory instrument made pursuant to section 2(2) of the Act is *Oakley v Animal Ltd (Secretary of State for Trade and Industry intervening)* [2006] Ch 337. That case concerned the secondary legislation implementing Directive 98/71/EC, which required member states to approximate their legislation in relation to registered designs but gave them an option to retain in force existing legislation for designs registered under that existing legislation. The Secretary of State for Trade and Industry exercised her powers under section 2(2) of the Act to make the Registered Design Regulations 2001 to implement the directive and, by regulation 12, retained in force the existing legislation, namely the Registered

---

5 Regulation 3 defines a *"non-natural person"* to mean *"any corporate body, unincorporated firm, partnership or body with legal personality except an individual, including any such entity constituted under the law of a country or territory outside the United Kingdom or any such entity constituted under international law"*.

6 Belgium, Denmark, Estonia, Finland, France, Germany, Italy, Luxembourg and Spain.

7 *Commission evaluation report to the Council and the European Parliament on the Directive* COM(2006)833 final dated 20 December 2006, paragraph 4.2.1.

8 For example, the Czech Republic, France and Sweden have included specific kinds of receivables, such as credit or other claims in the list of assets which may serve as collateral under the Directive. See the report referred to in footnote 7, paragraph 4.1.1.

Designs Act 1949 ("the 1949 Act"). The claimant began proceedings to prevent infringement by the defendants of certain designs under the 1949 Act. On the trial of a preliminary issue, it was held at first instance that regulation 12 was invalid in that it was not passed either for the purpose of *"implementing any Community obligation of the United Kingdom"* under section 2(2)(a) of the Act or of *"dealing with matters arising out of or related to any such obligation"* under section 2(2)(b). The Court of Appeal (Waller, May and Jacobs LJJ) allowed an appeal against the trial judge's decision on the validity issue, holding that regulation 12 *had* been passed for the purpose of *"implementing any Community obligation of the United Kingdom"* under section 2(2)(a) of the Act.

4.2 It was therefore not necessary in that case to construe section 2(2)(b) of the Act. However, the Court of Appeal took the opportunity *obiter* to express views on those provisions, as well as stating its views on section 2 (2)(a). The Court of Appeal concluded that section 2 is *sui generis* and, unlike other provisions allowing for the amendment of primary legislation by secondary legislation, flows directly from the United Kingdom's obligations under Article 249 of the EC Treaty[9] which, in relation to directives, provides that *"A directive shall be binding, as to the result to be achieved, upon each member state to which it is addressed, but shall leave to the national authorities the choice of form and methods."* The correct approach in relation to regulations made under section 2(2)(a) is to construe them by reference to the Directive.[10]

---

9 *Per* Waller LJ at paragraph [19].

10 *Ibid* at paragraphs [20] and [28]. See also Jacob LJ at paragraph [65]: *"One test as to whether or not a directive is properly implemented is to compare the directive with the purportedly implementing statutory instrument. If there is nothing in the latter which is not explicitly contemplated in the Directive … then it is a case falling within section 2(2)(a). In such a case, the statutory instrument is made* ***solely*** *for the purpose and* ***solely*** *for enabling implementation."*

4.3 In relation to section 2(2)(b), Waller LJ stated:

> *… I do not for my part equate the words 'related to' or 'arising from' in this subsection with 'not distinct, separate, or divorced from' (the language used by Otton LJ* [11]*). I would endorse his words that they should be given their natural meaning but as we know context means everything. That context is the bringing into force under Section 2 of the laws, which under the Treaties the United Kingdom has agreed to make part of its laws. The whole section is clearly primarily concerned with that obligation and the primary objective of any secondary legislation under Section 2(2) must be to do just that. Section 2(2)(b), and the words 'arising from' and 'related to' take their context from that being the primary purpose of Section 2.* ***It seems to me that Section 2(2)(b) from its position in Section 2, from the fact that it adds something to both subsection (1) and (2), and from its very wording is a subsection to enable further measures to be taken which naturally arise from or closely relate to the primary purpose being achieved.*** *I accept that I will be accused of adding the words 'naturally' and 'closely', but I believe that describes the context which provides the meaning of the words.* [12]

4.4 May LJ agreed with Waller LJ's reasoning.[13] He observed that:

> *…I do not consider that to hold that the making of these transitional provisions came within section 2(2)(a) has the effect of making section 2(2)(b) devoid of content. There is a distinction between providing something which, although it is a choice, is a choice which the implementation of the Directive requires you to make, and one which is not so required, but* ***which has the effect of tidying things up or making closely related original choices which the Directive does not necessarily require****. Section 2(2)(b) is confined by its words and context. Redefinition in the abstract is to be avoided.*[14]

4.5 Jacob LJ also agreed that section 2(2)(b) added something to the mere implementation of Community legislation:

> *How much more must depend on the particular circumstances of the case – the statutory language is the guide. It says 'for the purpose of dealing with matters arising out of or related to'. Whether a particular statutory instrument falls within those words must depend on what it purports to do and the overall context. One cannot put a gloss on the meaning. If Otton LJ was adding a gloss – "distinct, separate or divorced from it" – then I do not agree with that gloss. You just have to apply the statutory language to the case concerned. And in doing so you bear in mind that the purpose of the power given by the section is European – the Art.10 purpose. Whether or not Otton LJ was right in the circumstances of Unison, I, like Lord Johnston,*[15] *do not decide. It would not be right to do so in the absence of the affected parties.*

4.6 Subsequent to *Oakley*, the validity issue in the context of section 2(2) of the Act has arisen in *Crane v Sky In-Home Service Ltd and The Secretary of State for Trade and*

---

11 In *R v Secretary of State for Trade and Industry, ex parte UNISON* [1996] ICR 1003, 1004.
12 Paragraph [39]. Emphasis added.
13 Paragraph [41].
14 Paragraph [47]. Emphasis added.
15 In *Addison v Denholm Ship Management (UK) Ltd* [1997] ICR 770 EAT (Sc), 785.

Industry [2007] EWHC 66 (Ch). There, the claimant argued that regulations 2(3) and (4) of, and the Schedule to, the Commercial Agents (Council Directive) Regulations 1993 were *ultra vires* as being out with the authority to make secondary legislation conferred by section 2(2) of the Act. Briggs J rejected the claimant's argument.

4.7 In doing so, he identified the principles to be derived from *Oakley* as follows:[16]

> *a) The question whether any particular delegated legislation is authorised by section 2(2)(a) does not demand a line by line analysis of the directive which it purports to implement. Parliament must be taken to have known in 1972 that directives frequently contain options or choices or other matters left to the discretion of Member States, and chose to leave the making of those choices and the exercise of those options and discretions to the designated Minister or Department, subject to the important reservations in Schedule 2 (such as imposing or increasing taxation, the making of retrospective legislation, the conferring of further power to sub-delegate and the creation of new criminal offences). Subject to those reservations, the powers in section 2(2) should be broadly construed: See per Waller LJ at paragraph 19 -29, per May LJ at paragraphs 44 – 46 and per Jacob LJ at paragraphs 61 -67.*
> *b) If there is nothing in a statutory instrument purportedly made under section 2(2)(a) which is not explicitly contemplated in the relevant directive, the section will have been complied with because the statutory instrument will necessarily have been made solely for the purpose of the directive and for enabling its implementation: see per Jacob LJ paragraph 65. In this context I interject that it may not matter much whether any particular provision in the statutory instrument is best understood as implementing a Community obligation, enabling any such obligation to be implemented or enabling any Treaty rights to be enjoyed by the United Kingdom, so long as one of those three alternatives applies. A right to derogate from the general objectives in a Directive is a Treaty right, because Directives take their force from the Treaty.*
> *c) Section 2(2)(b) of the ECA is properly invoked by any provisions in a statutory instrument which constitute "further measures to be taken which naturally arise from or closely relate to the primary purpose being achieved" see per Waller LJ at paragraph 39.*
> *d) Further or alternatively, if there is a distinction between the making of a choice which a Directive requires a Member State to make, and one which is not so required, but which has the effect of tidying things up or making closely related original choices which the Directive does not necessarily require, then such choice falls within section 2(2)(b), if not within section 2(2)(a): see per May LJ at paragraph 47.*

4.8 Applying those principles, Briggs J concluded that the parts of the domestic regulations under challenge were authorized by section 2(2)(a) or, if necessary, section 2(2)(b) of the Act.[17]

4.9 The validity issue also arose in *R (on the application of Parker) v Bradford Crown Court* [2007] RTR 30, [2007] ACD 44, in which section 2(2) (b) of the Act alone was

---

16 Paragraph 37 of the judgment.

17 *Ibid*, paragraphs 38-44.

upheld as the basis for the validity of the secondary legislation in question.[18] The question in that case concerned the validity of domestic regulations made under section 2(2) which extended the scope of section 170 of the Road Traffic Act 1988 so as to include a *"public place"*, as the EU Commission suggested was required by applicable Community directives. The Divisional Court (Waller LJ and Lloyd Jones J) held that there was no power under section 2(2)(a) to make the regulations but that the necessary power was to be found in section 2(2)(b):

> *35. The United Kingdom government was faced with legislation that had been passed, seeking to implement EC Directives. The House of Lords*[19] *construed it narrowly and in a way which the Commission would suggest had led the United Kingdom to be in breach of their obligation. What was required was only a minor amendment, aimed at the same mischief, bringing the legislation into line with what the Commission viewed as fulfilling that obligation. The decision to pass the Regulations clearly arose out of or related to the obligation which they had sought to implement…*

4.10 The court rejected the claimant's submission, made in reliance on *Oakley*, that the necessary power lay in section 2(2)(a). Whereas in *Oakley* the United Kingdom had chosen one of the options clearly left to the member states under the directive, without expansion or amendment of that option, in the instant case the government had chosen to introduce domestic legislation which on any view went further than the directive but which, at the same time, fulfilled the obligation to bring in a particular law.[20]

4.11 There is, therefore, no reported case where a challenge to the validity of domestic secondary legislation made under section 2(2) has been successful.

---

18 See also *Transport & General Workers Union v Swissport (UK) Ltd (in administration) and Aer Lingus Ltd* [2007] ICR 1593, a decision of the Employment Appeal Tribunal (HH Judge Serota QC) where it was held, applying *Oakley*, that the extension, by domestic regulations made under section 2(2) of the Act, of the protection afforded to employees in certain insolvency situations under the Acquired Rights Directive arose out of or related to the implementation of the Community obligation within section 2(2)(b).

19 In *Clarke v General Accident Fire and Life Insurance Corporation* [1998] 1 WLR 1647.

20 *Per* Waller LJ at paragraph 32.

5. The *vires* of the Regulations

5.1 Against this background, it is necessary to consider the validity of the Regulations. It is intended to focus on the extension of the Directive to collateral arrangements where both parties are non-natural persons introduced by regulation 3 of the Regulations.

5.2 Applying the principles to be derived from *Oakley* as identified by Briggs J in *Crane*, it is suggested that the necessary power cannot be found in section 2(2)(a) of the Act: the extension introduced by regulation 3 is not *"for the purpose of implementing any Community obligation of the United Kingdom, or enabling any such obligation to be implemented, or of enabling any rights enjoyed or to be enjoyed by the United Kingdom under or by virtue of the Treaties to be exercised"* within the meaning of those provisions.

5.3 On that basis, the question comes to be whether section 2(2)(b) confers the necessary power. Again, applying the principles to be derived from *Oakley* as identified by Briggs J in *Crane*, it is submitted that, for the reasons summarised below, the answer is clearly yes, since the extension introduced by regulation 3 "*naturally arise*[s] *from or closely relate*[s] *to the primary purpose being achieved"* by the Directive (Waller LJ) or else has *"the effect of tidying things up or making closely related original choices which the Directive does not necessarily require"* (May LJ).

5.4 As already observed in general terms, the purpose of the Directive is to promote the integration and cost efficiency of the financial markets and the stability of the financial system. As is clear from the preamble to the Directive,[21] the benefits of common rules in relation to collateral constituted to payment and security settlement systems was demonstrated by the implementation of Directive 98/26/EC on settlement finality in those systems. The desirability was recognised of a Community regime:

> *for the provision of securities and cash as collateral under both security interest and title transfer structures including repurchase agreements (repos) This will contribute to the integration and cost-efficiency of the financial market as well as to the stability of the financial system in the Community, thereby supporting the freedom to*

[21] Recital (1).

> *provide services and the free movement of capital in the single market in financial services.* ***This Directive focuses on bilateral financial collateral arrangements****.* [22]

5.5 The Directive, consistently with the Community's approach generally in the financial sector,[23] lays down only a minimum regime relating to the use of financial collateral: recital (22) in the preamble. The introduction of minimum conditions for financial collateral arrangements is but one step on the road towards the integration and cost-efficiency of the financial markets.

5.6 Given that the Directive does no more than lay down a minimum regime, there is nothing objectionable in a member state choosing to extend the personal scope of the Directive beyond that minimum regime in order to apply the same principles as are laid down by the Directive to a wider range of financial collateral arrangements. There is nothing inconsistent with the Directive in such an approach. On the contrary, such an approach fosters the Directive's objectives.

5.7 The fact that the Directive only creates a minimum regime undermines any argument that the Regulations are *ultra vires* because the Directive is dealing only with financial collateral arrangements in the wholesale financial markets. Put another way, any such argument fails to appreciate that the Community's ultimate objective is a fully integrated and cost-efficient financial market which supports the freedom to provide services and the free movement of capital in the single market in financial services and which is not circumscribed by the boundaries of the Directive itself.

5.8 A consideration of the *travaux préparatoires* further supports the validity of the extension introduced by regulation 3. These show that the limitations in the scope of the Directive, requiring one party to be a financial institution, occurred relatively late in the negotiation process. In particular:

(a) When setting out the principal objectives of the Directive in its Proposal for a Directive of the European Parliament and of the Council on financial collateral arrangements (the Proposal), the Commission referred to the objective of

---

22 Recital (3). Emphasis added.

23 That approach has been consistently followed by the Community in the financial services sector since the First Banking Directive of 12 December 1977: see Dassesse, Isaacs and Penn *EC Banking Law* (2nd ed, 1994), paragraph. 3.3 and the Court of Justice's description of that directive in *Commission v Italy* [1983] ECR 449, 455 and *Commission v Belgium* [1983] ECR 467, 476.

ensuring that effective and reasonably simple regimes exist for the creation of collateral under either title transfer (including repo) or pledge structures…

There was no mention, in the Proposal, of restricting the application of the Directive so that one party to a collateral arrangement must be a financial institution. Indeed, in the early stages of the Proposal, the proposed scope of the Directive was very wide, including not only collateral arrangements between companies but also allowing for sophisticated individual investors to be parties to financial collateral arrangements. The width of the proposed scope of the Directive reflected the views of several papers published on the need for a satisfactory regime governing collateralisation in the EU.

(b) By March 2001, the draft Directive still encompassed within its scope the ability for both parties to a collateral arrangement to be companies. The focus had shifted to the threshold for allowing a company to benefit from the Directive, with a suggested limit of a capital base exceeding EUR 100 million or gross assets exceeding EUR 1000 million.

(c) The more restrictive terms regarding the scope of the Directive first appeared in the Report of the Committee on Economic and Monetary Affairs on the Proposal. At this stage amendments proposed by the European Parliament abolished the threshold referred to above to enable all companies to benefit from the Directive with the restriction that their counterparty always be a financial institution. No reason was given as to the narrowing of the scope of the Directive so that one counterparty must always be a financial institution.

(d) An opt-out clause was also added by the Council allowing Member States to exclude entirely non-financial companies from the scope of the Directive. The Council's reasons for this opt-out were

to strike the right balance between the need not to enlarge the scope of the Directive unduly to the detriment of other creditors in an insolvency situation on the one hand and, on the other hand, the need to ensure that the aims of the Directive can be achieved…

The reasons for the opt-out are also found in the communication from the Commission to European Parliament, namely that

> *certain Member States found that the inclusion of all kind of financial companies might lead to difficulties concerning the ranking of creditors.*

Given that the comments regarding the opt-out in the communication from the Commission to European Parliament appear in the same paragraph as the comments on the amendments to the scope of the Directive to include all companies provided that one counterparty is a financial institution, it would appear that the concerns of Member States about the priority of creditors were also behind this change to the scope of the Directive. Indeed in the Evaluation Report on the Financial Collateral Arrangements Directive the attention paid to the scope of the Directive and the eventual opt-out was attributed to the fact that:

> *special treatment for collateral arrangements could be seen to be contrary to the general principle of equal treatment of creditors within insolvency proceedings.*

5.9 Given that, during the process of the Directive's drafting and negotiation, collateral arrangements between companies were expressly contemplated and the concerns which may have led to a narrowing of the Directive's scope do not apply in relation to arrangements between companies in the UK, it is clear that the extension in regulation 3 must arise out of or relate to the Directive.

5.10 It is also of some significance that, as already observed, a total of 10 member states[24] should have chosen to enlarge the Directive's scope to cover entities not referred to in the Directive. That fact does not, of course, of itself demonstrate the validity of the Regulations. What it does demonstrate is that the United Kingdom was not alone in determining that the fulfilment of the Directive's objectives necessitated or made desirable the application of its principles to a wider range of financial collateral arrangements than those covered by the Directive itself. The International Swaps and Derivative Association's Margin Survey 2007 shows how the mix of counterparties to financial collateral transactions varies across size categories and includes not only

---

[24] Belgium, Denmark, Estonia, Finland, France, Germany, Italy, Luxembourg and Spain.

financial institutions but institutional investors, corporates and other counterparties (for example SPVs and commodity trading firms.)[25]

5.11 In the United Kingdom, the existing position prior to the implementation of the Directive was that many of its provisions already applied irrespective of the identity of the parties. This was one of the justifications advanced by the Treasury, in addition to the overall policy objective, for the extension made by regulation 3 of the Regulation and for its decision not to exercise the right afforded by Article 1(3) of the Directive to exclude from the scope of the implementation of the Directive financial collateral arrangements where one of the parties is a person mentioned in Article 1(2)(e).[26]

---

25 ISDA Margin Survey 2007, paragraph 4.3.

26 Paragraph 2.2 of the Treasury's consultation paper of July 2003 entitled *Implementation of the Directive on Financial Collateral Arrangements*. Another justification was that to have exercised the opt-out would have been contrary to the overall policy objective. A further justification that the extension was regarded as simplifying implementation of the Directive by avoiding the need to reproduce in domestic law the elaborate definitions of Article 1(2)(c) of the Directive and as making the law clearer, simpler and more consistent has perhaps less force.

FINANCIAL MARKETS LAW COMMITTEE MEMBERS

Lord Woolf (Chairman)

Bill Tudor John, Lehman Brothers (Deputy-Chairman)

Peter Beales, LIBA

Dr Joanna Benjamin, London School of Economics & Political Science

Michael Brindle QC, Fountain Court

Keith Clark, Morgan Stanley International Limited

Simon Dodds, Deutsche Bank

Sir Terence Etherton, The Law Commission[27]

Ruth Fox, Slaughter and May

David Greenwald, Goldman Sachs International

Mark Harding, Barclays

Sally James, UBS Investment Bank

Clive Maxwell, HM Treasury[28]

Guy Morton, Freshfields Bruckhaus Deringer

Gabriel Moss QC, 3-4 South Square

Habib Motani, Clifford Chance LLP

Ed Murray, Allen & Overy LLP

Steve Smart, AIG Europe (UK) Ltd

Paul Tucker, Bank of England

Secretary: Joanna Perkins, Bank of England

---

[27] Sir Terence Etherton abstained from discussions surrounding FMLC Issue 132 and involvement in the preparation of this paper in recognition of his prior official responsibilities.

[28] Clive Maxwell abstained from discussions surrounding FMLC Issue 132 and involvement in the preparation of this paper in recognition of his prior official responsibilities.