DECEMBER 2010

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 87 – CONTROL

GRAY v G-T-P GROUP LTD

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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 87 - CONTROL

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1. INTRODUCTION

1.1. The role 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.

1.2. The FMLC has long been concerned with uncertainties arising in connection with financial collateral. Recently, some of these uncertainties have crystallised with the recent decision in *Gray v G-T-P Group Ltd, Re F2G Realisations Ltd* [2010] EWHC 1772 (Ch) ("*Gray*"). The decision has highlighted pre-existing uncertainty about whether floating charges over financial collateral fall within the protections afforded to security over financial collateral by Directive 2002/47/EC (the "Directive") and the Financial Collateral Arrangements Regulations (No 2) 2003 (the "Regulations").

2. EXECUTIVE SUMMARY

2.1. This paper considers:

(i) Background to the Directive and the Regulations

(ii) *Gray*

(iii) Impact of the uncertainties on the financial markets, in particular on:

a. Prime brokerage

b. Securitisations

c. Margin loans; and

d. Initial margin segregation products

(iv) Proposed solutions

3. BACKGROUND TO THE DIRECTIVE AND REGULATIONS

3.1. The Directive was introduced in order to harmonise differing national regimes for the provision of securities and cash as collateral, and to simplify the process of taking and enforcing security over such assets.

3.2. The provision of financial collateral underpins a vast number of transactions in the financial markets. It enables parties to have comfort as to the assets available to meet their claims should the collateral provider become insolvent. Not only does the provision of collateral underpin transactions in the financial markets in general, it also forms the basis for the infrastructure supporting the financial markets, in particular through charges given in favour of clearing systems and central banks.

3.3. The Directive covers collateral in the form of cash, securities and (from 6 May 2009) credit claims.

3.4. The Directive was intended to remove the formalities/perfection requirements applicable to financial collateral, to disapply certain insolvency law provisions in relation to collateral arrangements, to recognise title transfer arrangements and close-out netting provisions, and to provide a conflict of laws rule for intermediated securities.

3.5. In the UK, this principally meant:

(i) the removal of the requirement to register charges over financial collateral at Companies House; and

(ii) the disapplication of certain provisions of insolvency law, including the moratorium on enforcement of security that would otherwise arise on the commencement of administration proceedings.

4. GRAY V G-T-P GROUP LTD

4.1. *Gray* is the first case to consider whether a floating charge can constitute a security financial collateral arrangement within the meaning of the Regulations.

4.2. *Gray* concerned the administration of F2G Realisations Ltd (the "Company"), a retailer of laminated floors. The Company had entered into an arrangement with the defendant, G-T-P Group Ltd ("G-T-P"), under which G-T-P agreed to collect debts owed to the Company. Sums collected by G-T-P were paid into a bank account in the name of G-T-P. However, under a declaration of trust between G-T-P and the Company, the Company was entitled to call for the money in the account at any time prior to the occurrence of an event of default with respect to it. If an event of default occurred, G-T-P would be entitled to withdraw from the account an amount equal to any sums due from the Company to G-T-P and apply them in the discharge of those sums.

4.3. It was admitted that these arrangements amounted to a charge over the account in favour of G-T-P and the points at issue were whether the charge was fixed or floating and, if so, whether it was exempt from having to be registered by the Regulations. If the charge was registrable, it would be unenforceable against the administrators of the Company, since registration had not been effected. On the first of these points, Vos J concluded that the Company's unrestricted right to withdraw money in the account prior to an event of default meant that the charge had to be characterised as a floating charge. This is uncontroversial, as it is clear that it is the right to control the charged assets that is the hallmark of a floating charge. He then moved on to consider the more difficult issue, namely whether the charge fell within the scope of the Regulations.

4.4. On this point, the judge noted that floating charges over financial collateral fall within the scope of the Regulations only if the collateral is "delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker or a person acting on its behalf" (Regulation 3). He concluded that, "since possession has no meaning in English law as regards intangible property", the real question was whether G-T-P had control over the collateral. Although G-T-P had physical control of the collateral, since it was in an account in its name, this was held to be insufficient.

4.5. Three reasons were given for this conclusion. First, the Regulations expressly provide that any right of the collateral provider to substitute equivalent

collateral or withdraw excess collateral does not prevent the collateral taker from having possession or control. If the Regulations applied even if the collateral provider had a right to withdraw everything in the account, it would have been unnecessary to provide that they apply if it had a right to withdraw excess collateral. Secondly, the Collateral Directive, on which the Regulations are based, explains that the objective is to "provide for some form of dispossession". From the usage in the Directive, this was taken by the judge to be referring to a situation in which the legal right to the charged asset is removed from the collateral provider. Thirdly, "control" was held to be a reference to legal control, so that the collateral taker can prevent the collateral provider from dealing with the collateral, rather than control in an administrative or practical sense.

4.6. This reasoning is, however, difficult to support. The judge's conclusion that possession has no meaning in English law as regards intangible property restricts the application of this concept to bearer securities in certificated form: a type of collateral which is rarely, if ever, seen. It also creates a distinction that has no basis in logic. The Regulations make it clear that it is sufficient for the collateral taker to have possession or control. If bearer securities are delivered so as to be in the possession of the collateral taker, the Regulations will apply even if the collateral provider has a legal right to demand the return of the securities. On the basis of the judge's view, however, the reverse is true if securities are transferred to the collateral taker in dematerialised form. It is very hard to see why it should it make any difference whether the collateral taker's interest is a direct holding of certificated securities or an indirect holding of dematerialised securities.

4.7. The "control" referred to in the Regulations is not a reference to legal control but to the type of control that is analogous to the concept of "possession", namely physical control. There is no need to require physical control where the collateral is in the collateral taker's possession, since this is necessarily implied by the existence of possession. In contrast to Vos J's approach, therefore, it is logical that it should be expressed as an alternative requirement.

4.8. In any event, it is incorrect to interpret the term "possession" simply by

reference to English law concepts. As the Regulations implement the Collateral Directive, this word must have the meaning intended by the Directive, which is designed to apply to all member states. It is reasonable to suppose that the word was not intended to have a narrow technical meaning but to denote a concept of general application. Indeed, the Directive explains that the objective is to provide for "some form of dispossession", equating this to the provision of collateral so as to be in the possession or control of the collateral taker or its agent. No distinction is drawn between different types of collateral, suggesting that its antonym, "possession", is also intended to apply to all types of collateral. Possession of securities, therefore, should be regarded as synonymous with holding the securities, even in dematerialised form.

4.9. This conclusion is also supported by the policy considerations that underlie this requirement. The Directive's 10th recital explains that the rationale is to:

> *provide a balance between market efficiency and the safety of the parties to the arrangement and third parties, thereby avoiding inter alia the risk of fraud.*

4.10. The safety of the parties to the arrangement can be achieved by ensuring that the collateral taker has physical control of the collateral (whether by possession or otherwise), thereby preventing the collateral provider from dissipating the collateral in breach of its agreement. Legal control is not needed for this. Even if the collateral provider were able to remove all the collateral from the arrangements on demand, so as to release it from the scope of the charge, there would be no prejudice to the collateral taker, as this would be no more than the parties had agreed.

4.11. The same applies to third parties. Here, the risk of a third party unwittingly acquiring an asset that is subject to a prior equity, or of the collateral provider exaggerating the value of its unencumbered assets, is eliminated where the collateral provider no longer holds the assets, regardless of whether it has the right to demand their return. In these circumstances, the collateral provider is prevented from delivering an asset subject to a prior equity. It can only do so by withdrawing the asset from the collateral arrangements, thereby releasing it

from the charge. Similarly, where the collateral provider no longer holds an asset, it cannot falsely claim that they form part of its unencumbered assets. In neither case is legal control required.

4.12. The reasons given by Vos J do not adequately address these issues. His suggestion that the usage in the Directive shows that legal control is required fails to identify the meaning he had in mind and, in any event, is contradicted by the considerations outlined above. His assertion that control means legal control does no more than (re)state the conclusion. Only the first of the reasons given (that the existence of an express right to withdraw excess collateral suggests that the collateral provider's rights would otherwise be limited) has any real substance. However, the objective of this provision is probably to remove any doubt about the impact of such a provision. In other words, it is designed to ensure that the Regulations should be construed widely rather than given a narrow construction.

4.13. The judge's finding means that the floating charges fall outside the Regulations (unless the only reason a floating charge exists is because the collateral provider has the right to withdraw excess collateral or substitute equivalent collateral). This is a surprising conclusion, given that the Regulations expressly state that they include floating charges (where the requirement for possession or control is satisfied). As a result, the protections given by the Regulations to financial collateral arrangements are not available to such charges, regardless of how the collateral is held. Amongst other things, this means that an unregistered charge will be unenforceable on the collateral provider's insolvency. With collateralisation now used as one of the cornerstones to protect the financial markets (and the wider economy) against the failure of a bank or an investment firm, the case sets an unwelcome precedent at a crucial time.

5. IMPACT ON THE FINANCIAL MARKETS

5.1. For the reasons noted above, the current legal position imposes significant burdens in the form of the cost of registration, delays and consequent legal and operational risk. Collateral arrangements underpin and reduce the risk of many

types of financial transactions, such as repurchase transactions (repos), OTC derivatives, stocklending, margin lending, securitisations, exchange traded derivatives and commodities transactions.

5.2. Since the original intention of the Directive and the Regulations was to:

(i) limit credit risk in financial transactions;

(ii) create a clear, uniform pan-EU legal framework for the use of collateral; and

(iii) to contribute to the greater integration and cost-efficiency of European financial markets;

it is clear that, in light of the uncertainties in the current legislation highlighted by *Gray*, further legislation is required to achieve this aim in the UK.

5.3. There are two key situations in which it was expected that the current Regulations would achieve significant efficiencies:

(i) where a collateral taker allows a collateral provider or its agents to substitute or manage collateral while leaving the overall balance or value of collateral unchanged, with the intention of either maximising returns for both creditors and collateral provider or minimising risks to both collateral provider and collateral taker; or

(ii) where a collateral provider or its agent has a discretion to withdraw and/or deal with collateral up to a limit.

5.4. If neither of these efficiencies can be achieved, the markets affected will include, *inter alia*: prime brokerage, securitisations, margin loans, and segregated collateral or initial margin arrangements.[1] These are discussed in greater detail below.

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[1] Where the only issue is the existence of the collateral provider's right to substitute or withdraw excess collateral, this alone will not prevent the collateral taker acquiring "control" for the purposes of the Regulations.

Prime Brokerage

5.5. Prime brokerage (i.e. margin lending and custody services rather than OTC intermediation) is a service provided by banks and investment firms that encompasses custody, stock lending, finance through loans and/or overdrafts.

5.6. To provide security for custody fees, loans of cash and stock loans owed to the prime broker and its affiliates, the client typically creates security, in the form of a fixed and floating charge, over the cash and securities held by the prime broker on its behalf. To support the fixed charge, the relevant documentation may provide for the prime broker's consent prior to release of cash or securities. Nonetheless, it is not unusual for a prime brokerage client's cash and securities accounts to be traded upon very regularly indeed, and day-to-day monitoring may result in intra-day margin calls. In practice, therefore, the prime broker may not give any consideration to each requested settlement and the question arises whether the consideration given is sufficient for the arrangements to constitute a fixed charge. In reality, consents, unless they might breach the relevant collateral threshold, are little short of automated. In these circumstances there is a risk that the arrangements will be recharacterised as a floating charge under the House of Lords' judgement in *National Westminster Bank plc* v *Spectrum Plus Limited and others* [2005] UKHL 41.

5.7. In light of the above, banks and investment firms involved in providing prime brokerage services, took some comfort from the provisions of the Regulations providing that

(i) a floating charge may constitute a security financial collateral arrangement as long as the relevant financial collateral is in the possession of or under the control of the collateral taker or its agent; and

(ii) that any right of the collateral taker to substitute financial collateral or withdraw excess financial collateral shall not prevent the financial collateral being in the possession of or under the control of the collateral taker.

5.8. *Gray* has now exacerbated concerns about whether such arrangements do constitute a security financial collateral arrangement. In the context of prime brokerage those concerns can be particularised as follows:

(i) whether the control exerted by the prime broker is “real legal control” and is sufficient for the purpose of bringing arrangements within the Regulations’ safe harbour;

(ii) whether the combination of a contractual right vested in the prime broker to allow the collateral to be withdrawn and to refuse a legal title to the relevant securities is sufficient to establish “possession”; and

(iii) what constitutes an excess for the purposes of the Regulations.

5.9. In the case of a prime brokerage arrangement it is also fundamental that the arrangements are capable of immediate termination, netting and set off. To the extent that there is a material risk that the arrangements might be subject to a moratorium on insolvency, because the Regulations’ safe harbour does not apply, this will affect the prime broker’s risk analysis of the arrangements and increase credit exposure in the markets. Moreover, it is not clear why, as a matter of principle, registration ought to be required in this scenario. Although registration is needed where the charge covers the collateral provider’s entire undertaking and assets in order to avoid creating a risk of false wealth, where the collateral taker is holding the assets, the risk of false wealth is less pronounced. As will be seen, in these circumstances, the situation is similar to a fixed charge.

Securitisations

5.10. Securitisation and structured finance in general can take a multiplicity of forms, often (but not always) encompassing a limited recourse financing of a pool of assets which have been sold to a bankruptcy remote, orphan special purpose vehicle. Such a vehicle funds its purchase by issuing notes to investors (with a junior tranche of notes or shares held by the original seller of the pool of assets, the so called “equity tranche”, which will be entitled to any upside on

the portfolio of assets over the life of the financing transaction) secured on the relevant portfolio of assets by way of a purported fixed charge.

5.11. Securitisations typically involve multiple classes of creditors and it is common for the arrangements to involve a custodian and a security trustee. While it is often the case that transactions will involve a static portfolio of assets it is not unusual for transactions to involve a greater or lesser degree of management, typically by a collateral manager (who is often related or affiliated to the holder of the junior tranche) appointed by the special purpose vehicle. Again, while documents may contain standard contractual limitations on the collateral manager's power to deal with the assets secured for the benefit of creditors of the special purpose vehicle, in practice most requests to realise or substitute assets will be accepted by the security trustee and/or the senior noteholders unless they breach certain agreed triggers. For these reasons concerns persist that such arrangements are subject to being recharacterised as a floating charge.

5.12. To the extent the arrangements outlined above may suffer from being characterised as a floating charge, they also suffer from uncertainty as to whether they fall within the safe harbour provisions of the Regulations and in particular whether:

(i) the actions of the collateral manager actually constitute substitution or withdrawal of excess collateral (for example, if collateral withdrawn is not an excess, but is simply withdrawn and sold to redeem senior note tranches); and

(ii) in general, whether it is possible to say that the arrangements confer real legal control on the noteholders or security trustee for the purposes of analysing control in the sense it is used in the Regulations.

5.13. While other elements of the structure of such transactions may provide comfort to creditors in respect of their recourse and rights (typically any vehicle will be structured to be bankruptcy remote), it is certainly true that the uncertainties outlined contribute to more complex structures and legal documentation (and thus cost for market participants and investors).

Margin Loans

5.14. A margin loan is a loan, secured against a defined portfolio of assets, often held in a custody account maintained by the collateral provider with the collateral taker.

5.15. While static portfolio margin loans do occur, it is often the case that the portfolio is managed by the collateral provider, subject to the consent (or negative consent) of the collateral taker and compliance with pre-agreed limitations on the collateral taker's authority. Practically, the collateral taker may not require individual consent for each transaction but may impose general constraints such as pre-agreed limitations and will, in any event, retain a right of oversight of the portfolio.

5.16. As rehearsed in the sections above, the method adopted for the management of a portfolio begs the question whether the arrangements constitute either a fixed charge or a security financial collateral arrangement. These concerns are heightened by the fact, unlike securitisation structures, the borrower will probably not be a transaction-specific, bankruptcy-remote vehicle (and therefore the lender has considerably less comfort as to its overall credit exposure.

Initial Margin Segregation Products

5.17. "Initial margin" is typically used to mean an amount of collateral that must be posted to a clearing house or exchange in excess of the variation margin which reflects the market value of the exchange-traded contracts. Although the term originated in the world of exchange traded derivatives, it is often used in relation to OTC derivatives and other bilateral mark-to-market financial contracts. Such over collateralisation is used to protect the collateral taker from the market risk associated with market movements in the time between the occurrence of a default or other termination and the time taken to liquidate relevant hedging positions or contracts.

5.18. As set out in more detail in the paper in relation to independent amounts under OTC derivatives published jointly by ISDA, SIFMA and the Managed Funds

Association,[2] often parties (for example funds and/or hedge funds) will find it desirable or mandatory to ensure that any initial margin is segregated from the bankrupt or insolvent estate of the collateral taker.

5.19. There is clearly a tension between the need for a pool of collateral to remain segregated from the collateral taker's insolvent estate and the need for a collateral taker to have control for the purposes of the Regulations. For example, to the extent that a collateral provider proposes a structure where the relevant accounts holding initial margin or independent amounts are maintained in the name of the collateral provider, even where such accounts are blocked and the relevant custodian is on notice of the relevant security interest, doubt must remain as to whether the "real legal control" referred to by the court in *Gray* is present. Such issues:

(i) severely fetter the discretion of the parties to structure the arrangements in a manner to minimise both cost and credit risk; and

(ii) potentially limit access and/or increases the costs for end-users of accessing derivatives markets for legitimate trading and hedging purposes.

6. SOLUTIONS

6.1. As discussed above, *Gray* appears to give rise to the odd position that it is not possible under English law to create a floating charge security financial collateral arrangement under the Regulations over financial collateral. If *Gray* is correct, then, given that the Directive expressly contemplates floating charges, this position represents a gap in the implementation of the Directive into English law. If *Gray* is not correct, then at the very least it has created significant uncertainty. The FMLC believes HM Treasury could use its powers under Section 2(2) of the European Communities Act 1972 or Section 255 of the Banking Act 2009 to align the Regulations with the Directive and bring clarity to this area.

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2 Available at http://www.isda.org.

6.2. While HM Treasury's recent consultation contemplates bringing system charges and collateral security charges within CREST within the scope of the Regulations,[3] the FMLC considers that all floating charges should fall within the scope of the Regulations, bearing in mind that the Directive expressly contemplates floating charges over financial collateral, so inclusion of only CREST security arrangements within the Regulations would be an incomplete implementation of the Directive.

6.3. Two possible approaches for achieving clarity are set out below.

Approach 1 - Possession

6.4. The first approach is to amend the Regulations to insert a partial definition of the term "possession" in regulation 3.

6.5. Before *Gray*, it was widely believed that, for the purposes of the Regulations, possession of financial collateral included the case where the collateral was credited to an account in the name of the collateral taker or a person acting on his behalf. Such a view appears consistent with the policy objectives of the Directive and with the position in many other EU jurisdictions. The judge in *Gray*, however, applied an historical English law concept to this aspect of the Regulations and suggested that possession has no meaning in respect of intangible property. As financial collateral is intangible property, by so doing, the judge in *Gray* effectively ruled out possession as a technique for creating a security financial collateral arrangement over financial collateral. Given that the Directive specifically provides for possession as a technique for creating security financial collateral, the FMLC does not believe this was the intention when the Regulations were drafted (indeed, if it had been, it would follow that the Regulations did not fully implement the Directive into English law). HM Treasury could clarify the position by inserting in the Regulations a definition of possession which reflects the widely-held view described above. The following text is suggested:

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3 "A consultation on the implementation of EU Directive 2009/44/EC on settlement finality and financial collateral arrangements", available at http://www.hm-treasury.gov.uk/consult_amending_directive_implementation.htm.

> *"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.*

6.6. To address the situation where a 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, it may be helpful to show that this case is also included within the concept of "possession" by the collateral taker, whenever the collateral is credited to the collateral taker's own account at a different (higher) level in the holding chain. If this further clarification is considered desirable, the following additional words may be added at the end of the proposed definition:

> *(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).*

6.7. The FMLC believes that, in the case of security financial collateral arrangements based on possession as defined above, there is very little risk that other creditors of the collateral provider would mistakenly think the collateral is available to them.

Approach 2 – Control

6.8. The second approach (which the FMLC views as additional to the first) is to amend the Regulations to insert a definition of "control" in regulation 3.

6.9. Frequently, in collateral arrangements, rights of substitution and withdrawal of excess collateral are given to the collateral provider. This is contemplated in the Directive itself (see for example Article 8(3)). The existence of such rights can lead to the characterisation of a charge under English law as floating rather than fixed for want of sufficient control. However, the judge in *Gray* applied this historical English law characterisation to the meaning of "control" for the purposes of the Regulations, indicating that the inclusion of complete withdrawal rights is incompatible with the collateral taker having "control" for

the purposes of the Regulations.

6.10. It is suggested that "control" for the purposes of the Regulations should include the following types of control:

(i) negative control, evidenced by the contractual agreement between the collateral provider and the collateral taker that the collateral provider will not dispose of, create security over (other than the security created in favour of the collateral taker) or otherwise deal with the collateral without the consent of the collateral taker. However, it should be made clear that

a. negative control can still be achieved in a collateral arrangement where the collateral provider has the right to substitute collateral or to withdraw excess collateral; and

b. consent would, for the avoidance of doubt, include the case where the parties pre-agree terms on which consent is deemed to be given by the collateral taker to a disposal/charge; and

(ii) practical (*de facto*) control, 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).

6.11. The FMLC envisages that both types of control should be applicable to bilateral collateral arrangements and to tri-party collateral arrangements (where a third party holds the collateral on behalf of either the collateral taker or the collateral provider and the collateral provider grants a security interest over (its rights in respect of) the collateral in favour of the collateral taker).

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