December 2012

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 1: COLLATERAL DIRECTIVE

Analysis of uncertainty regarding the meaning of “possession or ... control” and “excess financial collateral” under the Financial Collateral Arrangements (No. 2) Regulations 2003

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FINANCIAL MARKETS LAW COMMITTEE

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1. INTRODUCTION

1.1. The remit of the Financial Markets Law Committee (the "FMLC", or the "Committee") 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 wishes to draw attention to two issues that are giving rise to concerns regarding the interpretation of the Financial Collateral Arrangements (No. 2) Regulations 2003 (the "FCARs"): the meaning of "possession or … control" and the meaning of "excess financial collateral".

1.3. A paper prepared by the Committee in December 2010 identified issues arising from the decision in *Gray v G-T-P Group Limited* [2011] 1 BCLC 313, as a result of which the FCARs were amended.[1] Certain points of uncertainty remain, however, and developments in market practice have recently brought these issues into particular focus.

2. "POSSESSION" AND "CONTROL"

"Possession"

2.1. The FCARs, which implement the EU Directive on Financial Collateral Arrangements (the "FCAD"),[2] afford certain protections to, *inter alia*, security financial collateral arrangements. Pursuant to Regulation 3 of the FCARs, these are agreements (or other arrangements) evidenced in writing under which a security interest is created over financial collateral to secure "relevant financial obligations" owed to the collateral-taker, where the collateral-provider and the collateral-taker are non-natural persons and:

1 See FMLC paper dated December 2010, Issue 87: Control (*Gray v G-T-P Group Ltd*).

2 Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

> the financial 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.

2.2. The "possession" of financial collateral in the form of cash or financial instruments includes the case where:

> financial collateral has been credited to an account in the name of the collateral-taker or a person acting on his behalf (whether or not the collateral-taker, or person acting on his behalf, has credited the financial collateral to an account in the name of the collateral-taker on his, or that person's books) provided that any rights the collateral-provider may have in relation to that financial collateral are limited to the right to substitute financial collateral of the same or greater value or withdraw excess financial collateral.[3]

2.3. This is a non-exclusive definition of the term but, in view of the limits that are placed on the rights that a collateral-provider may have, it gives rise to uncertainty: it is not clear whether the collateral-provider can have any rights that go beyond a right to substitute financial collateral of the same or greater value or to withdraw excess financial collateral.

2.4. If, for example, the collateral-provider is allowed to take income accruing on the collateral or receive notices or exercise voting rights (relating to collateral in the form of securities), until enforcement, it is not clear whether this would prevent the definition of "possession" being satisfied. Equally, if the collateral-provider has responsibility, in the first instance, for determining the value of the collateral or the secured obligations (for the purpose of exercising a right to substitute, or withdraw excess collateral) the same problem arises. (These matters are discussed further in paragraphs 2.12 to 2.18 below.)

[3] This definition was inserted into the FCARs by Regulation 4 of the Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations 2010.

2.5. The FMLC believes that the FCARs should be amended to provide greater clarity regarding the meaning of "possession". The need for clarity has been reinforced by the recent decision in *Re Lehman Brothers International (Europe)* [2012] EWHC 2997 (Ch), in which the Court considered the meaning of the phrase "possession or … control" in Article 2.2 of the FCAD. The Article provides as follows:

> References in this Directive to financial collateral being "provided", or to the "provision" of financial collateral, are to the financial collateral being delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker or of a person acting on the collateral taker's behalf. Any right of substitution or to withdraw excess financial collateral in favour of the collateral provider shall not prejudice the financial collateral having been provided to the collateral taker as mentioned in this Directive.

2.6. As the FCARs seek to implement the FCAD, the equivalent phrase in the FCARs has to be construed accordingly. It was held that the key issue is whether the collateral-provider has been "dispossessed". Accordingly, the judge concluded (at paragraph 132) that the word "possession":

> requires something much more than mere holding by, or delivery or transfer to, the collateral taker.

However, referring to the definition of "possession" in the FCARs, the judge said:

> I am not however persuaded (as HM Treasury apparently has been) that the final sentence of Article 2.2 is a comprehensive description of the rights which may, after a qualifying provision, nonetheless reside with the collateral provider, such that the enjoyment by the provider of any different or

> wider rights would be fatal to the requirement for provision. It may well be that the draftsman regarded rights of substitution and withdrawal of excess as so common within modern forms of financial collateral arrangement that they needed to be preserved, in the new regime, for the avoidance of doubt.

2.7. Following this decision, the position is that:

(a) the definition of "possession" contained in the FCARs has been judicially disapproved, on the basis that it implements the FCAD too narrowly; but

(b) where reliance is placed on the ordinary meaning of the word "possession" (interpreted in the context of the FCAD), it is unclear what rights may reside with the collateral-provider without this preventing the collateral-taker from having "possession" of the collateral.

2.8. Given the importance of collateral in the financial markets (and its increasingly significant role in reducing systemic risk), it is undesirable that this uncertainty should be allowed to remain.

"Control"

2.9. A similar issue arises where collateral is held in an account in the name of the collateral-provider, rather than the collateral-taker. In these circumstances, the collateral-taker will not have "possession" of the collateral and the question is whether it has "control" of it.

2.10. Financial collateral arrangements increasingly involve the holding of financial collateral in this way (generally pursuant to a tripartite arrangement between the collateral-provider, the collateral-taker and the custodian), with the collateral-provider granting a security interest over the account in favour of the collateral-taker. This is driven partly by a concern amongst the clients of financial institutions that collateral deposited with a financial institution may not be returned promptly (or at all) in the event of the financial institution's insolvency and partly by the fact that, in New York, it is market practice for financial collateral to be held in this way.[4]

2.11. Even though, under such an arrangement, the collateral is not held in an account in the collateral-taker's name, the collateral-provider's ability to deal with the collateral is very limited. The collateral-provider is typically given the right to substitute financial collateral of the same or greater value or withdraw excess financial collateral. However, with the exception of any income that accrues on the collateral, will not be otherwise entitled to withdraw collateral from the arrangements while the secured obligations remain outstanding. This is reinforced by the fact that the custodian will undertake, pursuant to its contract with the collateral-taker and the collateral-provider, not to permit the collateral-provider to remove any collateral from the account while the secured obligations remain outstanding except in the agreed circumstances. Furthermore, if the custodian is notified by the collateral-taker that the security has become enforceable, the contract will require the custodian to act on the collateral-taker's instructions.

2.12. Such arrangements typically include the following features, each of which may prove challenging in analysing "control" as a matter of English law:

(a) the security interest may not extend to any income that accrues in respect of the financial collateral (at least where the security has not become enforceable), in which case the collateral-provider will be entitled to withdraw such income from the account;

(b) if any notices are received in respect of any collateral in the form of securities, the collateral-provider will be entitled to receive a copy of them;

[4] The FMLC has been given to understand that in New York and certain other European Union jurisdictions (notably Luxembourg and the Netherlands) it is possible to create a security financial collateral arrangement where the collateral is held in the name of the collateral provider and that a relatively high degree of legal certainty exists as to enforceability and perfection.

(c) the collateral-provider will usually be entitled to exercise any voting rights attached to any securities forming part of the collateral if the security has not become enforceable;

(d) the collateral-provider may be responsible for determining the value of the collateral or the secured obligations if these are not readily observable (as, for example, where the secured obligations are derivatives, which may have an uncertain and fluctuating value); and

(e) if the collateral-taker becomes insolvent, the collateral-provider will generally be entitled to require the custodian to return the collateral to the collateral-provider, although sometimes only after certifying that it has discharged the secured obligations.

2.13. It should be noted that, notwithstanding such a certification, there may be some uncertainty about whether the secured obligations have been discharged as they may have been quantified on the basis of a valuation made by the collateral-provider which is subsequently disputed.

2.14. The mere fact that the collateral-taker is able to restrict the collateral-provider's control of the collateral (rather than itself having actual control of the collateral) should not prevent the collateral-taker from having "control" of the collateral, since "negative control" is sufficient for the FCARs to apply (*Gray v G-T-P Group Limited*). However, it is unclear what restrictions must be imposed for such "negative control" to exist. Even when the arrangement provides for a strong degree of practical, economic control (or restriction of control by the collateral-provider) in respect of the collateral, there remains doubt about whether the arrangement will constitute a security financial collateral arrangement as a matter of English law. The following paragraphs (2.15 to 2.18) address the FMLC's preferred approach where uncertainty exists. Amendments are required before this approach can be implemented.

2.15. The FMLC considers that the fact that the collateral-provider has the right to receive income, or notices, relating to collateral in the form of securities, or exercise any voting rights, should not prevent the collateral-taker from having "control" of the collateral, if it would otherwise do so. These rights do not enable the collateral-provider to deal with the collateral and so their existence does not prevent the collateral-provider from being "dispossessed".

2.16. As regards valuations, the FMLC considers that the fact that the collateral-provider has the right to determine the value of the collateral (or any assets which may be substituted for collateral) should not prevent the collateral-taker from having "control" of the collateral (if it would otherwise do so) as long as:

(a) the exercise of any right of substitution or withdrawal of excess collateral depends on the collateral provider's determinations being verified by the collateral-taker or a third party (such as the custodian with which the collateral is held); or

(b) the collateral-taker is able to carry out such verification (or procure that it is carried out) and veto any exercise of a right of substitution or withdrawal of excess collateral if the collateral-provider's valuations cannot be confirmed.

2.17. In the latter case, it should be made clear that it is not necessary for the collateral-taker to verify the collateral-provider's determinations on each occasion (or at all), as long as it has the *ability* to do so. This implies that the collateral-taker (or a person nominated by it) must have sufficient information about any proposed substitution or withdrawal (together with the relevant valuations) to be able to investigate the position, the technical expertise to assess the validity of the collateral-provider's determinations and sufficient time to complete the verification exercise before the substitution or withdrawal takes place. The collateral-taker must also have the right to veto any substitution or withdrawal that is based on a valuation that cannot be verified. If these conditions are satisfied, the fact that the collateral-provider is responsible, in the first instance, for carrying out any necessary valuations should not prevent the collateral from being under the collateral-taker's "control".

2.18. The FMLC does not believe that it is appropriate for the collateral-provider to have an unrestricted right to require the release of the collateral from the collateral arrangements if the collateral-taker becomes insolvent. However, the fact that it is able to require such a release by certifying that the secured obligations have been discharged should not prevent the collateral-taker from having "control" over the collateral. To avoid the risk of fraud, this should be subject to two provisos. First, where the certification depends on a valuation that has been carried out by the collateral-provider, the collateral-provider should be required to act reasonably and in good faith. Secondly, the collateral-provider should be required to provide its certification to the collateral-taker as well as the person with which the account is held, with the right to withdraw collateral from the account arising only after a specified period has elapsed. This will provide the collateral-taker with sufficient time to seek an injunction if it believes that the certification has been provided fraudulently.

2.19. The FMLC believes that the FCARs should be amended to clarify the law in this area. The preferred solution is for the FCARs to provide expressly that the collateral-taker will be deemed to have "control" over collateral that is held in an account in the name of a third party (including the collateral-provider) if the collateral-taker has an agreement with the person with which the account is held that contains certain minimum features.

3. "EXCESS FINANCIAL COLLATERAL"

3.1. The FCARs provide that:

> any right of the collateral-provider to substitute financial collateral of the same or greater value or withdraw excess financial collateral … shall not prevent the financial collateral

> being in the possession or under the control of the collateral-taker.[5]

3.2. The phrase "excess financial collateral" is not defined and its scope is unclear. The word "excess" suggests a scenario in which there is more financial collateral than is required. However, it is not clear whether, on a strict construction of the term, this must be determined by reference to the value of the secured obligations, so that an "excess" arises only where the value of the collateral exceeds the value of the secured obligations or, alternatively, whether the parties are free to specify the amount of collateral that must be held, so that there is an "excess" if the value of the collateral exceeds that agreed amount.

3.3. If the parties are free to specify the amount of collateral that must be held, they might, for example, agree that the value of the collateral within the "possession" or "control" of the collateral-taker must at all times be not less than, say, 90 per cent of the value of the secured obligations, or not less than a stated sum. The fact that the collateral-provider has a right to withdraw collateral to the extent that it exceeds this amount would not prevent the FCARs from applying.

3.4. The FMLC considers that the FCARs should be amended to make it clear that an "excess" arises where the value (or estimated value) of the collateral exceeds the amount of collateral required to be posted from time to time under the agreement between the collateral-provider and the collateral-taker. This appears consistent with the FCAD, as can be seen from Recital 10 of the Directive, which explains that the rationale for requiring "some form of dispossession" 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.

[5] Regulation 3 of the FCAR.

If the collateral taker has agreed to accept a level of collateralisation that is less than the value of the secured obligations, there is no risk to its safety, or that of third parties, for the collateral provider to be entitled to carry out withdrawals in compliance with that agreement, and nor is there any risk of fraud.

4. CONCLUSION

4.1. The FMLC recommends, in view of the foregoing, that the FCARs be amended to make it clear that, provided that certain specified conditions are satisfied (see paragraphs 2.16 to 2.18 above), the fact that the collateral-provider has the rights described in paragraph 2.12 above will not prevent the collateral-taker from having “possession” or “control” of the collateral, if it would otherwise do so.

4.2. The FMLC also recommends that the FCARs be amended to make it clear that an “excess” arises for the purposes of the FCARs where the value of the financial collateral to which a security financial collateral arrangement relates exceeds an amount agreed between the parties, or determined by reference to a formula or any other criteria agreed between the parties.

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