Financial Markets Law Committee

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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

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