KEY POINTS
- Amendments to the Financial Collateral Arrangements Regulations came into effect in England on 6 April 2011.
- The Regulations ease formalities and aid enforcement for qualifying arrangements by which financial collateral such as cash or securities is provided.
- The amendments seek to widen the scope of the Regulations and clarify issues surrounding their application and operation.
- Despite the amendments, there are still some areas where uncertainty persists.

Feature

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A tentative step forward – amendments to the Financial Collateral Arrangements Regulations

On 6 April 2011, changes to the Financial Collateral Arrangements Regulations (the 'Regulations') came into effect in England. The Regulations are intended to promote the use of financial collateral (such as cash and securities) by reducing formalities and facilitating enforcement in the event of a collateral-provider's insolvency. The changes made by the amendments are incremental, rather than fundamental, although they do seek to resolve some of the legal issues which had previously plagued the Regulations. It is hoped that the amendments will help reduce the risk of disruption to financial markets upon insolvency of participants and ultimately reduce funding costs for financial institutions.

On 6 April 2011 changes to the Financial Collateral Arrangements (No 2) Regulations 2003 (the 'Regulations') came into effect in England, implementing EU Directive 2009/44/EC. The changes are incremental, rather than fundamental. They widen the scope of the Regulations, clarify the application and operation of the Regulations in particular circumstances, and remove an anomaly regarding the availability of appropriation as a means of enforcement. In this feature, the authors summarise the key changes made by the amendments and outline some of the areas where uncertainty persists.

HOW DO THE REGULATIONS WORK?

The Regulations only apply to 'financial collateral arrangements'. There are two types of financial collateral arrangements: title transfer financial collateral arrangements and security financial collateral arrangements. 'Financial collateral' was originally limited to cash and financial instruments (ie shares, bonds and other securities) but, as discussed below, has now been extended to credit claims. The Regulations do not apply where either the collateral-taker or the collateral-provider are natural persons.

A 'title transfer financial collateral arrangement' is an agreement or arrangement (including an English law repurchase agreement), evidenced in writing, where:

- the purpose of the arrangement is to secure or otherwise cover the relevant financial obligations owed to the collateral-taker; and
- the collateral-provider transfers legal and beneficial ownership in financial collateral to a collateral-taker on terms that when the relevant financial obligations are discharged the collateral-taker must transfer legal and beneficial ownership of equivalent financial collateral to the collateral-provider.

A 'security financial collateral arrangement' is an agreement or arrangement, evidenced in writing, where:

- the purpose of the arrangement is to secure the relevant financial obligations owed to the collateral-taker;
- the collateral-provider creates or there arises a 'security interest' in financial collateral to secure those obligations; and
- 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. As noted below, certain variations are permitted without affecting possession or control.

The security interests covered are broad: any legal or equitable interest or any right in security (other than a title transfer) created or otherwise arising by way of security including a pledge, a mortgage, a lien, a fixed charge and a charge created as a floating charge (but only where the possession or control test is met, as discussed further below).

If an arrangement is a 'financial collateral arrangement', the Regulations modify the application of certain aspects of English law that would otherwise apply. For example, certain formalities relating to the creation and perfection of such arrangements (including the requirement for registration) are disapplied. In addition, certain restrictions on the enforcement of security when the collateral-provider is in an English insolvency process are disapplied, making it easier for collateral-takers who have the benefit of the Regulations to enforce their security. In addition, collateral-takers who have the benefit of a financial collateral arrangement to which the Regulations apply are not subject to some of the priority limitations which would otherwise restrict their realisations (the categories have been expanded with the recent amendments).

THE NEED FOR CHANGE

The Regulations came into effect in December 2003 and were intended to promote the use of 'financial collateral' by reducing the formalities required to take and provide such collateral and facilitating the realisation of collateral in the event of the collateral-provider's insolvency.

Although relatively clear in objective, the scope and operation of the Regulations has been the subject of uncertainty and debate. In particular, the forms of financial collateral which fell within the terms of the Regulations were restrictive and the question of the application of the Regulations to collateral provided by way of a floating charge was riddled with uncertainty.

The recent amendments ostensibly seek to resolve, in part, the legal quandaries concerning the application of the Regulations and, in turn, the UK government has stated that it anticipates that this will reduce the risk of disruption 'to the key financial architecture of London's markets and potentially reduce funding costs in the form of collateral savings and additional liquidation available to financial institutions' (HM Treasury, Implementation of the EU Directive 2009/44/EC on settlement finality and financial collateral arrangements – summary of responses, December 2010, p 27). However, as discussed below, the amendments may potentially give rise to further problems regarding the practical operation of the Regulations and resolve existing ambiguities only to a limited extent.

SECURITY FINANCIAL COLLATERAL ARRANGEMENTS – EQUIVALENT SECURITY

As mentioned above, the Regulations provide for two forms of financial collateral arrangement: the title transfer financial collateral arrangement and the security financial collateral arrangement. In respect of security financial collateral arrangements, one of the key eligibility requirements is that the financial collateral must be 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.

The Regulations (as in force prior to 6 April 2011) gave the collateral-provider the ability to effect a substitution of collateral with 'equivalent financial collateral', and provided that such right of substitution would not prevent the assets being regarded as being in the possession or under the control of the collateral-taker for the purposes of the Regulations. The meaning given to 'equivalent financial collateral' by the Regulations was very narrow, such that the replacement collateral needed in substance to be identical to the collateral being replaced. In practice, this limited definition was restrictive and did not accord with the commercial reality of parties entering into financial collateral arrangements of this type, nor, it would seem, with the expectations of the European Central Bank and European Commission which had long recognised the commercial benefits of enabling collateral-providers to substitute financial collateral for collateral of an equivalent value. (See Opinion of the European Central Bank, 13 June 2001; Proposed Directive of Financial Collateral Arrangements (30 March 2001), p 3.)

The amendments to the Regulations have removed the reference to 'equivalent financial collateral' and have replaced it with an equivalent value concept, providing that any right of the collateral-provider to substitute financial collateral of the same or greater value (or withdraw excess financial collateral or collect the proceeds of credit claims) does not prevent the financial collateral being 'in the possession or under the control' of the collateral-taker. This refinement brings the Regulations into line with the commercial reality of parties transacting on the financial markets and managing portfolios of investments, which should in turn enable a wider range of arrangements to fall within the parameters and protections of the Regulations. However, as discussed below in relation to floating charges, there remains uncertainty as to what is required to satisfy the 'possession or control' element of the test.

POSSESSION OR CONTROL

As noted above, for a charge to be regarded as a 'security financial collateral arrangement' for the purposes of the Regulations, the collateral must have been 'delivered, transferred, held, registered or otherwise designated so as to be in the <u>possession or under the control</u> of the collateral-taker or a person acting on its behalf'. The collateral-provider is, however, permitted to substitute the collateral (now for collateral of the same of greater value) and withdraw excess collateral without affecting the possession or control requirement. Accordingly, a key issue is what is required to meet the 'possession or control' test.

In *Gray v G-T-P Group* [2010] EWHC 1772, the English High Court questioned whether the English law concept of 'possession' could apply to intangible property such as cash and dematerialised financial instruments. The judge therefore considered the question of 'control' and declined to find the trustee account holder had control over the account within the meaning of the Regulations because that control was simply administrative as opposed to substantive and the trustee-account holder could not prevent the beneficiary/chargor from dealing with the account. The court questioned whether the control test could ever be satisfied in the case of a floating charge. Following *Gray*, there was much concern that the application of the Regulations was more limited than intended.

Although the amended Regulations do not provide guidance as to the meaning of 'control', new reg 3(2) now provides a definition of possession. The definition is non-exhaustive and applies only to cash and financial instruments, but stipulates that a collateral-taker will be in possession of the relevant collateral for the purposes of the Regulations where the assets have been credited to an account of the collateral-taker, or a person acting on its behalf (whether or not the collateral-taker credits the collateral to an account in the name of the collateral-provider on its books), provided that the collateral-provider's only rights in relation to the collateral are limited to the right to substitute financial collateral of the same or greater value or to withdraw excess financial collateral. The latter limitation could be problematic for transactions (including, for example, custody arrangements) where the collateral-provider has greater rights than those provided for in reg 3(2). Nevertheless, new reg 3(2) brings much needed clarity to the meaning of 'possession', particularly in relation to intangible property. Consequently, the question as to what amounts to 'control', as discussed in *Gray*, is likely to be of less significance. If *Gray* was to be revisited it is likely that reg 3(2) would come into its own.

FLOATING CHARGES – IN OR OUT?

A significant proportion of the UK government's consultation paper regarding the amendments to the Regulations concerned the application of the Regulations to floating charges, which is a long-standing practical issue. However, although amendments have been made to clarify what level of possession of the assets is required, none of the amendments directly clarifies whether or not a given floating charge can be a 'security financial collateral arrangement' for the purposes of the Regulations.

Under English law, whether security is characterised as a floating charge usually turns on the question of control over the assets. A floating charge is normally characterised as such where the collateral-provider, until crystallisation of the charge, is free to control and manage the charged assets and remove them from the security without the chargee's permission: *Re Spectrum Plus* [2005] UKHL 41.

The new definition of 'possession' in reg 3(2) and the amended right to substitute collateral of equivalent value make it more likely that some types of floating charges could be regarded as 'security financial collateral arrangements'. However, there remains uncertainty about the extent to which floating charges can come within the scope of the Regulations, particularly where possession is, in practice, taken in a different way to that envisaged by reg 3(2). The terms of the HM Treasury consultation document and summary of responses clearly indicate that the discussion as to whether and how floating charges, or certain floating charges, could properly come within the Regulations has just begun. HM Treasury has indicated that a further consultation specifically on this issue may be required.

CREDIT CLAIMS

Prior to 6 April 2011, 'financial collateral' covered by the Regulations was limited to cash and financial instruments. The meanings attributed to cash and financial instruments were broad (encompassing cash standing to the credit of a bank account, money market deposits, balances due under close-out netting arrangements, shares, bonds and tradable securities), but receivables under bank loans did not qualify as 'financial collateral' for the purpose of the Regulations.

The definition now given to 'financial collateral' within the Regulations has been widened so as to include receivables on bank loans, referred to as 'credit claims' (ie 'pecuniary claims which arise out of an agreement whereby a credit institution .... grants credit in the form of a loan').

The European Central Bank has stated that the expansion of the forms of eligible financial collateral to which the Regulations apply reflects a long held belief that the inclusion of credit claims would 'further enhance the implementation of the single monetary policy of the Eurosystem' which, in turn, would benefit consumers and debtors as the increased 'pool of available collateral … could ultimately lead to more intense competition and better availability of credit'. Accordingly, a broader span of arrangements involving financial collateral may now take advantage of the provisions of the Regulations which dispense with the need to comply with domestic creation and perfection formalities, and benefit from the safe harbours which apply to protect the position of the collateral-taker on the insolvency of the collateral-provider.

No right of use

However, the inclusion of credit claims as eligible financial collateral has its limitations. Where cash and financial instruments are provided as financial collateral under a security financial collateral arrangement, reg 16 expressly preserves any rights which the collateral-taker has under the arrangement to use and dispose of the collateral as owner (provided that the financial collateral is replaced by equivalent financial collateral in due course). However, that preservation of rights of use does not apply where the financial collateral is a credit claim.

Exemption from formalities?

Financial collateral arrangements to which the Regulations apply are exempt from the domestic formality requirements regarding the creation, validity, perfection, enforceability or admissibility of a financial collateral arrangement or the provision of financial collateral. However, the Regulations do not completely obviate the need for formalities: the provision of financial collateral must still be evidenced in writing and the financial collateral must be identified between the parties to the arrangement.

In the case of credit claims, the European Financial Collateral Directive 2002/47/EC ('FCD'), to which the Regulations gave effect, provides that the provision to the collateral-taker of 'a list of claims submitted in writing or in a legally equivalent manner' would be sufficient to evidence the arrangement and identify the relevant collateral against both the debtor and third parties, which goes some way to recognising that credit claims are likely to be linked to a variety of third party interests. However, the FCD goes further and states that member states may continue to require formal acts 'for the purposes of perfection, priority, enforceability or admissibility in evidence against the debtor or third parties' (art 3(1)(i) FCD). Accordingly, member states may continue to insist on the fulfilment of formal acts to ensure a collateral-taker's interest in the credit claims is effective as against parties other than the collateral-provider (eg the underlying debtor).

Although the Regulations dispense with the need for certain formalities to occur as between the collateral-taker and the collateral-provider, they do not remove the requirement for notice to be given to third parties to the collateral arrangement who may have interests in the credit claims provided as collateral (ie the debtor). Notification to third parties is still likely to be required to ensure that, for example, the debtor directs payments to the correct account and to ensure that the collateral-taker has priority against subsequent secured creditors. Accordingly, the disapplication of formalities in respect of arrangements involving the provision of financial collateral in the form of credit claims may be of limited value in practical terms, although the inclusion of credit claims remains a positive development with regard to the objectives of the financial collateral regime.

FACILITATING ENFORCEMENT

Other amendments to the Regulations have rationalised the self-help remedy of appropriation by widening the circumstances in which

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the remedy of appropriation could be used by collateral-takers, and seeking to clarify the effect of appropriation on the interests of the collateral-provider in the financial collateral. Appropriation allows a collateral-taker to become the owner of the assets by a valuation (rather than a sale) process. Usually a court order would be required before appropriation could occur, but the Regulations permit the exercise of a contractual power of appropriation without a court order in the case of certain security financial collateral arrangements.

Before the amendments to the Regulations came into force it was only possible for collateral-takers with the benefit of a legal or equitable mortgage or charge to use appropriation as an enforcement remedy. However, reg 17(1) now extends this to other types of security interests (namely mortgages, fixed charges, pledges, liens and in some situations floating charges).

Further, new reg 17(2) states that after the collateral-taker has exercised the power to appropriate, the 'equity of redemption of the collateral-provider shall be extinguished and all legal and beneficial interest [of that party] shall vest in the collateral-taker'. While there is a slight oddity in the notion of a collateral-provider as chargor having an equity of redemption to be extinguished, the spirit of appropriation is clear; on default the collateral-taker is free to look forward and deal with the collateral without needing to be concerned with the ongoing interests of the collateral-provider. However, looking at the intermediated trust structure through which many securities are held and traded, in many instances it may not be the collateral-provider which in fact has any legal interest in the collateral to vest in the collateral-taker.

FOREIGN INSOLVENCY PROCEEDINGS

New reg 15A prevents an English court, when co-operating with a foreign court pursuant to s 426 Insolvency Act 1986, from giving effect to an order of that foreign court if the English court could not otherwise give effect to that order because of the Regulations.

On the one hand, this encourages legal certainty as between the member states with regard to the financial collateral regime. On the other, reg 15A appears to contradict the current trend of the insolvency courts, which have taken a universalist and expansive approach to assisting and co-operating with foreign courts in relation to insolvency matters. How reg 15A will be applied in practice remains to be seen.

CONCLUSION

While the ultimate aim of the legislation at European level is to promote harmony between member states with regard to the taking and enforcing of financial collateral, it is not clear that the Regulations are capable of achieving this objective just yet. While the amended Regulations are now more coherent in their application to the various collateral arrangements which may be entered into, the continued uncertainty regarding the application of the Regulations to floating charges and need for further refinement as to what is meant by 'possession or control' suggests that the Regulations are far from being in their final form. ■

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