THE CITY OF LONDON LAW SOCIETY FINANCIAL LAW COMMITTEE

European Commission's Proposal for amendments to the Settlement Finality Directive and the Financial Collateral Arrangements Directive

To: H.M. Treasury

(A) Background

This paper sets out the views of the Working Group established by the Financial Law Committee of the City of London Law Society (the "CLLS") on the draft (Brussels 17 March 2008) Proposal for a Directive (the "Proposal") of the Commission for the European Communities amending Directive 98/26/EC on settlement finality in payment and securities settlement systems (the "SFD") and Directive 2002/47/EC on financial collateral arrangements (the "FCD").

The following persons are members of the Working Group:

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Whilst the views expressed in this paper are the views of the members of the Working Group, they do not necessarily represent the views of the law firms that they represent.

This paper has been drafted in a time-scale which is exceptionally short. Further issues may arise as the detail becomes clearer and as the market has a greater opportunity to digest the implications of the Proposal.

Section (B) of this paper sets out comments on the Proposal insofar as it affects the SFD and Section (C) of this paper sets out comments on the Proposal insofar as it affects the FCD. Section (B) substantially reproduces comments made by Travers Smith on behalf of Euroclear. We are grateful to both Travers Smith and Euroclear for giving their consent to this.

Members of the Working Group would be very happy to meet with representatives of HM Treasury in order to clarify any points made in this paper, should this assist.

(B) The Proposal insofar as it affects the SFD

1. Proposals for interoperability under the SFD

1.1 As a general proposition, we support the proposals to provide legal clarity and certainty in the application of the SFD to 'interoperable systems' – by the proposed addition of new Article 3(4) (moment of entry) and a sub-paragraph in Article 5 (moment of irrevocability).

1.2 However, two issues arise.

- In the context of some interoperable arrangements, we believe that it is desirable to provide for the overriding and governing effect of one system's rules in relation to a transfer order that enter that system, but is ultimately executed (or settled) in another system. The proposed Article 3(4) and 5 may, inadvertently, prevent such a solution because of the mandatory language used (i.e. "One system's rules [of entry][on moment of revocation] shall not be affected by any rules of the other systems with which it is interoperable"). We need some flexibility that recognises that the relevant system operators may agree that the moment of entry and/or irrevocability of a transfer order that enters an interoperable system may be governed exclusively by the rules of one of the systems.

- The proposed clarifying provisions are expressed to apply only to 'interoperable systems'. However, as recognised at pages 6 and 7 (under paragraph 6.1.2 of the Proposal), the issues identified apply equally to systems that are linked not only through 'interoperability', but also through standard access and customised access. We see no reason why the proposed changes to Article 3(4) and 5 should be limited to 'interoperable systems' (as defined). They should be extended to 'linked systems' (which may be linked through standard access, customised access or interoperability).

2. 'Systems' as participants

2.1 In the UK and Ireland, we have dealt with the issue identified by the European Commission (at paragraph 6.1.2 of the Proposal) that a system "cannot currently be a participant", by utilising the power to treat as "institutions" any corporate body that participates in a designated system – where the designating authorities consider this to be warranted on grounds of systemic risk in accordance with Article 2(b) of the SFD.

2.2 The express inclusion of a 'system' as a 'participant' (in new Article 2(f)) will not affect this analysis. However, there does seem to be a rather confusing and inaccurate inter-change between the terms 'system' and 'system operator' as used in the proposed amendments to the SFD. We would expect the term 'system operator' to be used in those Articles that assume the embodiment of the system as a 'legal personality'. For example, insolvency proceedings would be commenced against the operator of a system. However, the term 'participant' has been defined to include 'system' – we would have expected the term 'system operator' to be the appropriate term here. As, for example, there are other provisions in the proposed amending Directive where the distinction between 'system' and 'system operator' is important (e.g. in new Article 10), we would recommend consistent and correct use of these respective terms in order to avoid legal uncertainty.

2.3 On a related issue, we consider the proposed definition of 'system operator' needs to be amended to avoid any confusion with an 'outsourcee' that may actually be "in charge of" the day to day operation of a system. We would suggest that it would be preferable to utilise the concept of contractual or legal responsibility for the operation of the system (as is the clear intention from the comments contained in paragraph 6.1.2 of the Proposal), for example:

"… the entity that *has legal responsibility* for the day to day operation of a system".

3. Proposed change to definition of 'indirect participant'

3.1 We support the extension of the concept of 'indirect participant' to indirect participants in a securities settlement system. This would protect designated securities settlement systems from the adverse effects of an insolvency affecting a member's principal. For example, a CREST member may hold securities as nominee or agent for another person and, if a petition to wind-up were presented against the principal (who subsequently goes into compulsory liquidation), a transfer in CREST effected through the CREST member (as nominee/agent) may be invalidated under section 127 of the Insolvency Act 1986.

3.2 However, we think there are three issues that may need to be pursued in relation to this concept.

- An indirect participant is required to be in a contractual relationship with an 'institution'. However, it is conceivable that an indirect participant might have a contractual relationship with a 'participant' which is not an 'institution' (e.g. a settlement agent, central counterparty or clearing house), but it would still be warranted on grounds of systemic risk to treat such an indirect participant as a participant. Accordingly, we would recommend including in the definition not only an institution, a central counterparty etc. that has a contractual relationship *with an institution*, but also such a body that has a contractual relationship *with a participant*.

- In order to be of potential benefit to the UK's designated systems, it will need to be clarified that a person can be an 'indirect participant' even if it itself does not pass transfer orders through the system. The present definition is unclear on this point. The concept needs to cover a person who uses a 'direct participant' to pass transfer orders through the system 'for' the indirect participant pursuant to the contractual relationship between them.

- Further, the potential benefits associated with the extension of the protections of the SFD to 'indirect participants' of a securities settlement system are likely to be lost if (as currently drafted in Article 2(f)) the indirect participant is required to be "known to the system". We wonder whether systemic stability could be enhanced, consistent with the rationale behind this requirement, if Article 2(f) were amended to allow for an indirect participant whose "identity is required, in accordance with the rules of the system, to be made known to the system operator". This requirement might then be met if the rules of the system, binding on the direct participant, can require the direct participant to disclose the name of any indirect participant(s) where such disclosure is required in the interests of systemic integrity. A system operator is unlikely to be concerned to identify all clients to whom its members may be providing nominee or agency services, unless and until an insolvency event occurs in relation to such a principal with potential systemic consequences for the system. This is an *ex post facto*, rather than an *ex ante,* process. This would, in addition, require some further modification to new Article 10 which currently imposes an obligation upon a system operator to notify the designating authority of any possible indirect participants or changes in them – a generic description of the potential class of such indirect participants should be a permissible means of satisfying this obligation if the actual identity of individual indirect participants is not known.

4. Transitional provisions

It is essential in the interests of legal certainty and the continuing, seamless SFD protection for existing designated systems that:

- new Article 10 does not affect the continuing SFD protections afforded to systems designated prior to the amending Directive having effect – there is an additional requirement to notify the Commission of the identity of the 'system operator' which (as it is new) may not have been satisfied in the case of existing designated systems and there needs to be some 'grandfathering' provision to ensure that there is no inadvertent failure of SFD protection for such systems; and

- it is made clear that transfer orders receive protection under the amended SFD even if they entered a system prior to the amending Directive having effect.

(C) The Proposal insofar as it affects the FCD

1. Collection of the Proceeds

1.1 The new Article 2.2 ensures that the possession or control requirement[1] can be met, at least in relation to the proceeds of credit claims, even though the collateral provider has the right to collect the proceeds. This would appear to disapply the *Spectrum*[2] concept of control where, in order to assert a fixed security interest, the chargee must have control over the proceeds as well as over the claim itself. It seems that a lower standard of control is intended to be applied to credit claims than to other forms of financial collateral. Consistency dictates that the standard of control should be lowered for other asset classes.

1.2 We would therefore suggest that the words "or, in the case of credit claims, to collect the proceeds thereof", should be replaced by the words "or to collect and deal with financial collateral and the proceeds thereof". This minor amendment to the wording should, of itself, overcome many of the concerns that we have expressed regarding the loss of the protections provided by the FCD in circumstances in which it may not be possible to be confident that the possession or control requirement is met.

1.3 Further, or alternatively, it would be useful if "control" could be defined so to include negative control (see paragraph 7.8 onwards of the CLLS Replies (the "Replies") to the Commission Questionnaire of February 2006). A similar wider concept of control appears in the current draft of the UNIDROIT Convention[3].

1.4 We should also point out that the possession or control requirement does not apply under the SFD in relation to a "collateral security charge". In order to improve legal certainty and ensure greater consistency between the SFD and the FCD, we suggest that the FCD be amended to disapply the possession or control requirement to a financial collateral arrangement which satisfies the test of being a "collateral security charge" under the SFD. This would ensure, for instance, that system-charges given to CREST settlement banks in the form of floating charges were protected by both the SFD and the FCD (as amended) when implemented into English law. As stated in our

[1] See Article 2(2) of the FCD and the explanation of references to financial collateral being "provided".

[2] *National Westminster Bank v Spectrum Plus and Others* [2005] UKHL 41.

[3] Draft of July 2007.

paper to H.M. Treasury of 25 August 2005, given the very large amounts at stake, it is eminently sensible to clarify the position by providing expressly that such charges are protected by the UK regulations implementing the FCD.

1.5 The amendment to the new Article 2.2 or the new definition of "control" would be helpful unless H.M. Treasury is confident that it can overcome the difficulty which currently exists in relation to the "possession or control requirement" through primary domestic legislation in the near future.

2. Credit Claims

2.1 Article 1.4(a) has been amended so as to include "credit claims eligible for the collateralisation of central bank credit operations". We understand that the definition of "credit claims" in Article 2(1)(o) may now be expanded to include certain minimum criteria broadly reflecting the criteria applied by the European Central Bank (the "ECB") to determine eligibility. It will in any event be important that the criteria that are included are clear and can easily be applied in practice.

2.2 The Evaluation Report of 20 December 2006 pointed out that the ECB Governing Council had in 2004 decided to introduce credit claims as an eligible type of collateral for Eurosystem credit operations as of 1 January 2007.

2.3 It is understood that the reason for allowing credit claims to be counted as eligible collateral is to prevent it becoming "immobilised" in the balance sheets of credit institutions. It is suggested that extending eligible collateral to credit claims could provide a useful complement to securitisation.

2.4 The current "credit crunch" means that it has become more difficult to securitise credit claims. It will be important to ensure that the amendment to the Directive can be used by UK credit institutions so as to ensure they do not suffer a competitive disadvantage compared to those established within the Euro-zone. We therefore suggest that the Bank of England should be invited to review the criteria so that, if it decides to follow the lead taken by the ECB, no further amendments will be required to made to the FCD in order to ensure that the Bank of England's criteria on eligibility match those set out in the FCD.

2.5 If, in addition to or in the alternative to the minimum criteria, the Directive adopts a test by reference to central bank credit operations, it should be made clear whether that is limited to European central banks or applies to all central banks.

3. Amendment to Article 3 – Formal Requirements

3.1 We notice that the word "perfection" which is present in the existing Article 3.1 is not included in the new sub-paragraph appearing at the end of Article 3.

3.2 We suggest that this should be included. Without it, it is likely that the parties will continue to regard it as prudent to register as a mortgage or charge pursuant to section 395 of the Companies Act 1985 any security given on credit claims by a company registered in any part of the United Kingdom or by a foreign company with an established place of business in Great Britain. In addition, if these words are not included, there would be a *vires* concern if HM Treasury proceeded to disapply section 395 Companies Act 1985 in relation to security over credit claims.

3.3 The explanatory note to the Proposal indicates that in some jurisdictions it might be considered beneficial to maintain registration and notification requirements for purposes other than the validity of a transaction, "(for instance opposability)". Is this intended to cover the priority of two competing claims? Is the Rule in *Dearle v Hall*[4] preserved?

3.4 The Proposal would mean disapplying section 395 of the Companies Act 1985 altogether in situations in which security was given on credit claims by a company to which the section applied; it would not in our view be practicable to implement Article 3 by allowing registration of the security out of time purely for priority purposes without substantial legislative changes (such as were intended to be implemented by the Companies Act 1989).

4. Definitions of "title transfer financial collateral arrangement" and "security financial collateral arrangement"

4.1 The explanatory note explains that the definition of "title transfer financial collateral arrangement" in Article 2.1(b) has been amended adding the words "or full entitlement to" to distinguish between ownership of cash or financial instruments on the one hand and "entitlement" to credit claims on the other. We are not sure that we follow the distinction that is being made here, although it may help to make it clear that legal ownership of the financial collateral is not required and that there can be a title transfer financial collateral arrangement even if legal ownership is vested (and continues after the transfer to be vested) in a third party (e.g. a custodian). Is it intended that this should extend to a sub-participation arrangement?

4.2 In paragraph 9.8 of our Replies, we suggested that the definition of "security financial collateral arrangement" in Article 2.1(c) of the FCD was not wholly consistent with the concept of a mortgage under English law; under English law, the collateral provider does not retain "full ownership" of the financial collateral but retains only an equity of redemption.

4.3 We also suggested that the word "full" in Article 2.1(c) should be deleted so as to make it clear that the FCD was intended to extend to legal mortgages of financial collateral. In the alternative, we note that in the draft UNIDROIT Convention this is resolved by referring to "the grant of an interest other than full ownership".

5. Waiver of Right of Set-off

5.1 It is not clear whether it is intended that this waiver should be capable of excluding insolvency set-off.[5] If this is the intention, perhaps the wording of the new Article 3(3) should expressly provide that set-off may be waived notwithstanding that it would otherwise be mandatory under the laws of any Member State.

5.2 It should also be made clear that waiver can be effective both against the original creditor as well as against any assignee.

5.3 The effectiveness of a waiver of a right of set-off is important to an assignee of a credit claim – whether within or outside the context of its insolvency. The assignee of a credit claim, whether taking the assignment as purchaser of the credit claim or by

[4] (1823-28) 3 Russ 1, [1824-34] All ER Rep 28.

[5] Rules 2.85 and 4.90 of the Insolvency Rules 1986.

way of security for the obligations of the assignor or a third party, needs to be confident that it may have recourse to the full value of the credit claim without any possible reduction by reason of a cross-claim of the debtor. The assignee could be a central bank or a private sector entity such as a commercial lender. That cross-claim may be against the assignor or any previous holder of the credit claim (if arising before receipt of notice of the assignment or if it is effective as an equitable or legal set-off); or may be against the assignee (where the assignee owes a mutual debt to the debtor). Where the instrument evidencing the credit claim contains a waiver by the debtor of any right of set-off which is effective in all cases, this may reduce the requirement of the central bank for a margin to be held as well as reducing systemic risk for credit institutions generally.

5.4 There is a countervailing policy argument where the assignee (not being a central bank) is insolvent. A right of set-off is particularly important on the insolvency of one of the parties. If there are cross-claims between the holder of a credit claim (H) and the debtor (D) and H becomes insolvent, D, in the absence of set-off, may be obliged to pay the full amount of his own indebtedness to H, and yet be confined to receiving a small or nil dividend along with other creditors for the amount for which the insolvent H is indebted to him.

5.5 The explanatory note does not explain the policy reason behind Article 3(3) except to say that "set-off may compromise the position of collateral takers in certain jurisdictions, since the collateral as such can disappear if the debtor exercises his set-off right vis-à-vis the creditors of the credit claim and vis-à-vis persons to which the creditors have assigned, pledged or otherwise mobilised the credit claim as collateral." The policy, in allowing the parties to contract out of set-off (including, presumably, insolvency set-off), therefore seems to be to provide assurance to the holder that, whatever the dealings between the original or any subsequent holder and the debtor, the credit claim will be paid in full and may be applied (where the assignment is by way of security) in payment or reduction of the credit extended by the assignee to the assignor or third party. This may be particularly important where the credit claim is taken as collateral for central bank credit operations.

5.6 To require a credit claim to be paid in full would be likely to be a matter of real concern were it not for the fact that the debtor is unlikely to be a consumer. The explanatory note makes it clear that protection will be available to the debtor if he is a consumer. It might be argued that a person who is not a consumer should be able to contract out of his set-off rights in all cases, even on insolvency. Generally, English law permits a debtor to waive his set-off rights except on an insolvency.

6. Right of Appropriation

Although we consider the position should be clear, it may be desirable to state expressly that the right of appropriation can be exercised without the financial collateral being registered or held in the name of the security taker (i.e. reversing the decision at first instance in the *Alfa Telecom*[6] case), whether the financial instruments or claims comprising the collateral are certificated or uncertificated and whether in registered or bearer form.

[6] High Court of the British Virgin Islands 25 September 2007 / 16 November 2007 reversed by the Court of Appeal of the Eastern Caribbean 29 January 2008 / 22 April 2008. We understand that there may be a further appeal to the Privy Council.

7. Hague

7.1 It is desirable that an attempt should be made to reconcile the conflict between Article 9 of the FCD and Article 4 of the Hague Convention[7]. The Convention provides that the governing law in force in the state expressly agreed in the account agreement or, if the account agreement expressly provides that any other laws should be applicable to govern proprietary issues affecting intermediated securities, that other law, should be applicable, subject in each case to a "reality test".

7.2 We would prefer that the principle set out in Article 4 of the Hague Convention should be adopted.

8. Close-out Netting

8.1 We propose that the provisions of the FCD that protect close-out netting should apply even if the relevant provisions are not contained in a financial collateral arrangement, or an arrangement of which a financial collateral arrangement forms part.

8.2 Certain of our members have advised upon cases in which it would have been useful to take advantage of the certainty provided by the FCD, but it was impossible to do so because the close-out netting provision was not contained in an arrangement of which a financial collateral arrangement formed part.

8.3 This could be achieved through a separate Directive if this was considered more appropriate.

9. Right of Use

9.1 The draft Directive adds a new Article 1(6) to the FCD providing that Article 5 of the FCD (which deals with the right of use of financial collateral under security financial collateral arrangements) shall not apply to credit claims.

9.2 The explanatory note to the Proposal indicates that the reason for this is that credit claims are not considered to be fungible and that a collateral taker who exercises his right of use cannot return equivalent collateral to the collateral provider at the end of the transaction.

9.3 We would suggest that in most cases in which credit claims are mortgaged or charged by way of security it should be possible for the collateral taker to return equivalent collateral. If a secondary market exists in relation to credit claims of the relevant description, we would suggest that it should be open to the parties to agree that the collateral taker should have a right of use so that at the end of the transaction he can purchase credit claims of the same description (i.e. credit claims against the same debtor arising under the same credit agreement, of the same class or description and of the same amount and currency) and deliver them to the collateral provider as equivalent financial collateral.

9.4 We would therefore recommend that the Directive should not add the new Article 1(6) to the FCD.

[7] The same point arises in relation to Article 9(2) of the SFD.

10. Drafting Amendments

10.1 We suggest that Article 1.2(d) of the FCD should be amended to cover (a) the situation in which the security is provided to the issuer itself to secure an onward loan made by it out of the issue proceeds to the originator (as in whole business securitisation) and (b) the situation where the issuer raises finance by issuing commercial paper and has a stand-by liquidity facility from a group of banks (paragraphs 7.10 of our Replies).

10.2 Although we consider the position to be clear if the wording is given a purposive interpretation, it may be helpful to have clarification of the definition of "financial instruments" in Article 2.1(e) so that it is crystal clear that the phrase "negotiable on the capital market" does not refer to shares (paragraph 7.12 of our Replies). This issue was conceded by the parties in the *Alfa* case, based on the evidence of the two experts (Lord Millett and Professor Ross Cranston, now Mr Justice Cranston) and the court expressly accepted and confirmed their answer on this issue (although the decision of the British Virgin Islands court is not, of course, a binding precedent in an English court). In this regard, it is noteworthy that in the recent European Commission position paper[8] on the UNIDROIT Convention, it was suggested that the concept of "financial instruments" as used in the FCD was limited to securities actually traded on an exchange or regulated market – which we understand is not the view taken by HM Treasury or the UK market generally.

10.3 We also propose that Article 2.3 should be amended so as to make it clear that "electronic means and any other durable medium" should include an electronic visual image (paragraph 7.13 of our Replies).

10.4 We suggest that Article 7 of the FCD should be expressed to prevail over the equivalent provisions contained in the Insolvency Regulation and in the Banks Winding-up Directive.

14 July 2008

[8] The Working Document dated 15 May 2008 prepared by the European Commission's Committee on Civil Law Matters on the "UNIDROIT draft Convention on substantive rules regarding intermediated securities" at paragraph 15.3 (page 20).