THE CITY OF LONDON LAW SOCIETY FINANCIAL LAW COMMITTEE WORKING GROUP ON THE IMPLEMENTATION OF THE FINANCIAL COLLATERAL ARRANGEMENTS DIRECTIVE

(1) CATEGORIES OF FLOATING CHARGE THAT SHOULD BE CAPABLE OF FORMING THE SUBJECT MATTER OF A SECURITY FINANCIAL COLLATERAL ARRANGEMENT NOTWITHSTANDING THAT THE FINANCIAL COLLATERAL MAY NOT BE IN THE POSSESSION OR UNDER THE CONTROL OF THE COLLATERAL-TAKER OR A PERSON ACTING ON HIS BEHALF

(2) "GAP" ANALYSIS ON (A) PROTECTIONS AVAILABLE TO CREST SETTLEMENT BANKS UNDER THE SF REGULATIONS AND (B) ON PROTECTIONS AVAILABLE TO COLLATERAL-TAKERS UNDER THE FCA REGULATIONS

1. SYSTEM-CHARGES AND COLLATERAL SECURITY CHARGES

1.1 As requested by Sarah Parkinson, a member of our Working Group has separately prepared a paper which provides a "gap" analysis of the protections available to CREST settlement banks and this is attached to this paper as Appendix I.

1.2 CREST settlement banks benefit from charges which are "system-charges" for the purposes of the Financial Markets and Insolvency Regulations 1996 (the "**FMI Regulations**") and "collateral security charges" for the purposes of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (the "**SF Regulations**"). The "gap" analysis paper identifies, amongst other things, those areas where such protections fall short of the protections provided to "security financial collateral arrangements" under the Financial Collateral Arrangements (No.2) Regulations 2003 (the **"FCA Regulations"**) and, for the reasons set out in that paper, concludes that it would be appropriate specifically to include system-charges and collateral security charges within the scope of the FCA Regulations (or otherwise extend such protections to such charges).[1]

1.3 We would emphasise that while there is a serious risk that system-charges etc fall outside the scope of the FCA Regulations, much depends upon how the control test is interpreted by the courts. If the courts apply a less strict construction than that which they have applied for the purpose of determining whether a charge should be characterised as a floating rather than as a fixed charge[2] and allow the control test to be satisfied if "negative control"[3] exists, then there will be good grounds for arguing that

[1] H.M. Government has already recognised that it is appropriate to include special safeguards for system-charges etc in legislation other than the FMI Regulations and the SF Regulations – see, for example, section 72F of, and Schedule A1 to, the Insolvency Act 1986 (the "**Insolvency Act**").

[2] See, for example, *Agnew v Commissioner of Inland Revenue* [2001] 2 BCLC 188 and *National Westminster Bank plc v Spectrum Plus Limited* [2005] UKHL 41.

[3] By "negative control", we mean that the collateral-provider and the collateral-taker have contractually agreed that the collateral-provider will not dispose of or grant a security interest in the financial collateral without the consent of the collateral-taker (with a provision making it clear that a right to substitute financial collateral or to withdraw excess financial collateral or otherwise to deal with the financial collateral until the occurrence of a specified crystallisation event (where the collateral-taker may take "positive" control) would not mean that negative control did not exist). It postulates that "positive control" in the sense explained in the *Agnew* and *Spectrum* cases referred to above does not, at least at the outset, exist.

system-charges etc are protected. However, given the level of legal uncertainty on this issue and the very large amounts at stake, it is in our view eminently sensible to clarify the position by stating expressly that system-charges etc are protected by the FCA Regulations.

1.4 On the basis of the analysis set out in the paper appearing as Appendix I and for the reasons given in it, we consider that it would be appropriate to bring such charges within the scope of the FCA Regulations. This is so even though, on a strict interpretation, the possession or control test imposed by the Financial Collateral Arrangements Directive[4] (and therefore that imposed by the FCA Regulations) may not be satisfied. The fundamental aims of market stability, integrity and confidence suggest that this is just the sort of situation in which the Directive was intended to provide protection.

1.5 The "gap" paper focuses, of course, on the reasons for extending the protections afforded under the Directive and the FCA Regulations to those "collateral security charges" in favour of CREST settlement banks. However, the following payment and settlement systems have also been designated in the UK under the SF Regulations: LCH Clearnet, BACS, CHAPS and CLS. Where collateral security charges are taken for the purpose of securing rights and obligations arising in connection with these other designated systems, the systemic integrity and market efficiency considerations outlined in the "gap" paper (as applying to CREST charges) would apply equally to such other collateral security charges. In addition, collateral security charges are given to a central bank for the purpose of securing rights and obligations in connection with its operations in carrying out its functions as a central bank. Accordingly, all collateral security charges (including, but not limited to, such charges in favour of CREST settlement banks) should be brought specifically within the scope of the FCA Regulations (or otherwise have the relevant protections extended to them).

2. MARKET CHARGES

2.1 A "market charge" under Part VII of the 1989 Act is a fixed or floating charge granted in favour of a recognised investment exchange or recognised clearing house for the purpose of securing debts or liabilities arising in connection with the settlement or performance of market contracts. Examples of recognised investment exchanges are the London Stock Exchange and the London Metal Exchange and examples of recognised clearing houses are Euroclear UK & Ireland and LCH Clearnet.

2.2 Section 175 of the 1989 Act disapplies certain provisions of the general law of insolvency in so far as they would otherwise apply to market charges and section 174 of the 1989 Act allows for regulations to be made for further modifying the law of insolvency in relation to them.

2.3 Amongst the provisions of the general law of insolvency that are disapplied are the restriction that applies when a company is in administration on the enforcement of security over the company's property without the consent of the administrator or the permission of the court[5] and the power of the administrator to deal with charged property[6] as well as (in certain circumstances) the statutory avoidance of any

[4] Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements (the "**Directive**").
[5] Paragraph 43(2) of Schedule B1 to the Insolvency Act 1986 (the "**1986 Act**").
[6] Paragraphs 70(1) and 71(1) of Schedule B1 to the 1986 Act.

disposition of property effected after the commencement of winding up.[7]

2.4 Again, it can be said that if it was thought appropriate in the interests of market stability and efficiency to exempt market charges from these provisions of insolvency law, it must also be appropriate to afford to them the benefit of the provisions of the Directive which allow security on financial collateral to be created and enforced with efficiency.

3. WHOLESALE ARRANGEMENT

3.1 In discussions with the Treasury and the Insolvency Service, it appeared to us that the Government would not wish to see the protections afforded by the Directive and the FCA Regulations made available to the holder of every floating charge over financial collateral regardless of whether the financial collateral could be said, on a strict interpretation, to be in the possession or under the control of the collateral-taker. The reason for this is thought to be that some of the protections facilitate the creation and enforcement of security over financial collateral at the expense or otherwise to the disadvantage of other creditors of the collateral-provider, and whereas these protections might be appropriate in some cases where (on a strict interpretation) there is no possession or control in the wholesale context, they are considered inappropriate where there is no such possession or control in a retail or consumer context. The provisions of the FCA Regulations that might be thought to be inappropriate where there is no such possession or control in a retail or consumer context include the disapplication of the requirement to register the security at the Companies Registry,[8] the inability of the administrators to deal with the charged property and the disapplication of the restriction on enforcing the security without the consent of the administrator or the permission of the court,[9] the avoidance of property dispositions effected after the commencement of the winding up,[10] the allocation of a prescribed part of the company's net property for unsecured creditors,[11] the avoidance of floating charges created by an insolvent company[12] and the payment of preferential debts out of assets subject to a floating charge.[13] This Working Group has previously recommended that the FCA Regulations should disapply those provisions of the Insolvency Act 1986 that require the expenses of administration to be paid out of the proceeds of realisation of the financial collateral ahead of the claims of the collateral-taker,[14] and, if this recommendation is accepted, the Government may well take the view that this provision also is inappropriate where there is no possession or control in the retail or consumer context.

3.2 If the protections afforded by the Directive and the FCA Regulations are to be made available in a wholesale context where (on a strict interpretation) there is no possession or control, the question that arises is how is "wholesale" to be defined. The suggestion has been made that there could be a “wholesale arrangement” exception based upon the capital markets exception to the general prohibition on the appointment of an administrative receiver.[15]

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[7] Section 127 of the 1986 Act.
[8] Regulation 4(4) of the FCA Regulations.
[9] Regulation 8 of the FCA Regulations..
[10] Regulation 10(1)(a) of the FCA Regulations..
[11] Regulation 10(3) of the FCA Regulations..
[12] Regulation 10(5) of the FCA Regulations..
[13] Regulation 10(6) of the FCA Regulations..
[14] See the comments of the Working Group on the draft Financial Collateral Arrangements (No. 2) (Amendment) Regulations 2005 set out in Appendix II, 2005, point 4.
[15] The prohibition is contained in section 72A of the 1986 Act and the exception is contained in section 72B of the Act.

3.3 The advantage of taking this exception as a starting point is that the exceptions to the general prohibition on the appointment of an administrative receiver were devised following extensive consultation with City practitioners, they are now familiar to financial institutions and practitioners and they have already been the subject of judicial scrutiny.[16] On the other hand, there is no logical connection between the commercial situations in which it might be appropriate to appoint as administrative receiver and those in which it might be appropriate to allow security to be created on financial collateral with the benefit of protections afforded by the Directive and the FCA Regulations in circumstances in which the collateral-taker may not have possession or control.

3.4 Our preference would not be to limit the protections to the very specific commercial situations in which an administrative receiver can be appointed (capital market arrangements, project finance, social landlords, protected railway companies etc) but rather to identify those elements which might be regarded as indicative of wholesale arrangements and to attempt to meld these elements together to form the basis of an exception that the Government and the European Commission would find acceptable. Although the capital market exemption is itself too narrow, we do think that it is a useful starting point for the new wholesale exception. In particular, it is helpful in identifying these sorts of arrangements where it is widely recognised that a floating charge over financial collateral is taken and, therefore, minimal fraud risk would be created by bringing them within the scope of the FCA Regulations (or similar protections) in the manner contemplated by Recital (10) of the Directive.

3.5 We would emphasise that we would not wish to see the protections afforded by the Directive and the FCA Regulations limited only to wholesale arrangements (or system-charges, collateral security charges or market charges); where the financial collateral is (on any interpretation, strict or purposive) in the possession or under the control of the collateral-taker, the security would continue to be protected. However, the protections would apply even if the financial collateral were not (on a strict interpretation) in the possession or control of the collateral-taker in a situation in which the security was granted under an agreement which was or formed part of a wholesale arrangement.

3.6 The key elements of a wholesale arrangement might be:

- the collateral-giver would be a "non-natural person" i.e. security granted by individuals would be excluded;
- the security would be granted in pursuance of an agreement which was or which formed part of a wholesale arrangement under which a party incurred or, when the transaction was entered into was expected to incur, a debt of at least a specified sum;
- the definition of a "wholesale arrangement" would be modelled on the definition of a "capital market arrangement" set out in Schedule 2A to the 1986 Act; and
- the definition would embrace both security granted to or for the benefit of a party to the arrangement in connection with the issue of a capital market investment and also security granted to or for the benefit of a party to the arrangement in connection with the incurring of debt to a Qualifying Person.

[16] See, for example, *Feetum and others v Levy and others* [2005] EWCA Civ 1601, [2006] 2 BCLC 102.

3.7 Please note that we would not wish to limit the definition to a situation in which money was raised on the capital markets although the key elements identified above should be sufficient in most cases to ensure that the exception would apply in such a situation.

3.8 The specified sum would not necessarily be the same sum as applies to the capital market exception.[17] "Qualifying Person" might be defined as either a person described in Article 1.2 of the Directive or a special purpose vehicle. The definitions and guides to interpretation set out in Schedule 2A should be included with the new definition of "wholesale arrangement".

3.9 We would be happy to submit draft wording for the exception if this would assist, but we would wish to know that HM Treasury agree in broad terms with what we propose should be the key elements to the exception.

4. GAP ANALYSIS IN RELATION TO THE FCA REGULATIONS

4.1 We attach as Appendix II a paper that we sent to HM Treasury in August 2005 commenting on the draft Financial Collateral Arrangements (No. 2) Amendment Regulations 2005 which had been informally circulated by HM Treasury to interested parties. This coupled with the amendments that were included in the draft itself (also included within Appendix II) should serve as a "gap" analysis in relation to the FCA Regulations in their current form.

5. IMPLEMENTATION

5.1 We have considered whether it might be possible to introduce the required changes (at least in relation to system-charges and market charges) under the delegated powers contained in section 174 of the Companies Act 1989, but we have dismissed this possibility as the scope of the powers is too narrow for this purpose.

5.2 It will be a matter for HM Treasury to determine whether it has *vires* under section 2(2) of the European Communities Act 1972 to bring system-charges, collateral security charges and market charges and wholesale arrangements within the scope of the FCA Regulations. HM Treasury should, however, be aware that there is real concern that, if section 2(2) were to be relied upon, there would be likely to be a challenge in the courts and therefore an amendment to the FCA Regulations based upon powers conferred by section 2(2) would be unlikely to provide the confidence that the market requires. If HM Treasury determine that they do not have the necessary *vires*, or that an amendment based on section 2(2) would not give confidence to the market, we would suggest that, in view of the systemic importance of such charges to the UK's financial markets, the protections which have been identified (and which are not currently made available) should be extended either through primary legislation or by a suitable amendment to the Directive itself. If Member States were permitted by the Directive to allow security interests to receive the protections afforded by the Directive without satisfying the possession or control requirement (for example, in circumstances in which they considered that it would be in the interests of market stability and efficiency), the powers conferred by the 1972 Act would in our view be sufficient to allow the exemptions to be granted without the need for primary legislation.[18] As a result of the recent consultation exercise[19], it may be possible to persuade the European

[17] Currently £50 million: see section 72B of the 1986 Act.

[18] See *Oakley Inc. v Animal Limited and others* [2005] EWHC 210 (Ch) and [2006] Ch 337 (CA).

[19] The European Commission asked Member States, the ECB and the EEA States at the beginning of 2006 to reply to a questionnaire regarding the implementation and application of the Directive. A less extensive

Commission that the Directive should be amended so as to relax the possession or control test in circumstances in which it would be in the interests of market stability and efficiency to do so.

5.3 We are aware that the European Commission is considering whether it might be possible to introduce an amendments to the Directive which would define "control" on a similar basis to that envisaged in the draft UNIDROIT Convention on Substantive Rules Regarding Intermediated Securities.[20] Whilst we would very much welcome such an amendment to the Directive, we consider that, if there is likely to be much further delay in finalising the wording of the Convention and thus any amendment to the Directive, HM Treasury should seek at the earliest opportunity to deal with the exclusion of system-charges, collateral security charges and market charges and also wholesale arrangements (ideally) by primary legislation without waiting for the wording to be finalised.

5.4 One of the "gaps" identified in our paper of August 2005 (see Appendix II, paragraph 4) in relation to the FCA Regulations was the failure to disapply certain provisions of the Insolvency Act that allowed the remuneration and expenses of the administrator and certain preferential debts to rank ahead of the claims of the holder of a security financial collateral arrangement which was expressed to be, or which was recharacterised as, a floating charge. Now that such priority is also to be afforded to the expenses of winding up,[21] a further disapplication is required. Again, this is likely to require either an amendment to the Directive (followed by regulations made by HM Treasury under section 2(2) of the 1972 Act) or primary legislation.[22]

5.5 It almost goes without saying that, if any of these changes are introduced by primary legislation, the opportunity should be taken to confirm the power of HM Treasury to make regulations allowing the benefits of the Directive to be conferred upon “non-natural persons” who enter into financial collateral arrangements even in circumstances in which one of the parties to the arrangements is not an institution as defined in points (a) to (d) of Article 1.2 of the Directive.

6. THE WAY FORWARD

6.1 We would be very happy to attend a further meeting with HM Treasury to discuss the foregoing and to submit draft wording for the wholesale arrangement exception assuming the key elements to the exception are agreed.

27 September 2007.

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questionnaire was also created for the private sector. On 20 December 2006, the Commission issued its Evaluation Report. The ECB also published in June 2007 a legal booklet containing a commentary on the Directive (as well as other directives) and a list of implementing measures in each Member State.

[20] The draft adopted by the 4th Session of the Committee of Governmental Experts on 21-25 May 2007 was published in July 2007. The definition of "control agreement" and the proposed Articles 10(6) and 34 provide a sensible basis for defining "control" that could be used in the Directive.

[21] Section 176ZA Insolvency Act as inserted by section 1282(1) Companies Act 2006, as from a day to be appointed.

[22] The possibility of amending the legislation by an order under Part 1 of the Legislative and Regulatory Reform Act 2006 should also be considered.

APPENDIX I

"GAP" ANALYSIS FOR CREST SETTLEMENT BANKS

A. Background

1. CREST is the securities settlement system for dematerialised UK, Irish and international equities, public sector securities and money market instruments. CREST is operated by Euroclear UK & Ireland Limited (**"EUI"**), formerly known as CRESTCo Limited. EUI is itself a recognised clearing house under the Financial Services and Markets Act 2000; an operator of a "relevant system" under the Uncertificated Securities Regulations 2001 (and equivalent regulations in Ireland); and operator of "designated systems" under the Settlement Finality Directive (the **"SFD"**).

2. Transactions settle in CREST on a Delivery-versus-Payment (DvP) basis. Payments approaching £750 billion are made each day through the system[23]. Such payments are only possible as a result of the credit and liquidity facilities which are provided to CREST participants by CREST settlement banks (consisting of leading UK, European and US financial institutions). Each CREST settlement bank will incur an exposure to its CREST participant-customer in relation to CREST payments that the bank makes for the account of the participant. The exposure arises because, under the inter-bank payment arrangements that support settlement, a settlement bank incurs an obligation as principal to effect payment at the moment of CREST settlement (for the account of its customer), but it will not seek reimbursement from the CREST participant until the end of the settlement day or at a later time. This obligation of reimbursement is usually secured by a floating charge taken by the CREST settlement bank over the participant-customer's (or its nominee's) CREST securities.

3. The importance of the functions performed by CREST settlement banks, and the need to provide appropriate protections for their security against the adverse effects of an intervening insolvency of the participant-customer, were first recognised by the FMI Regulations. The FMI Regulations give certain limited protections to such charges, as "system-charges", by applying Part VII of the Companies Act 1989 to them – the principal effect of which is to disapply the administration moratorium; the administrator's and administrative receiver's powers to dispose of charged property; the receiver's vacation of office and certain related matters in relation to system-charges (subject to certain temporal and other limitations).

4. Subsequently, the SF Regulations, which implemented the SFD in the UK, provided certain further protections to a settlement bank's charge (qualifying as a "collateral security charge") from the adverse effects of the insolvency of a CREST participant. The principal relevant aims of the SFD are:

   (1) to reduce the risks associated with participation in securities settlement systems, in particular where there is a close link between such systems and payment systems (Recital (2));

   (2) to contribute to the efficient and cost-effective operation of cross-border payment and securities settlement systems in the EU (Recital (3));

[23] CREST Newsletter Issue No. 124, July 2007.

(3) to minimize the disruption to a system caused by insolvency proceedings against a participant (Recital (4));

(4) to reduce systemic risk by allowing for the enforceability of collateral security (Recital (9)); and

(5) to insulate collateral security from the effects of insolvency law applicable to the insolvent participant (Recital (18)).

5. Article 9(1) of the SFD provides that collateral security should not be affected by insolvency proceedings against a participant and that such collateral security may be realised for the satisfaction of a participant's (i.e. in the CREST context, a settlement bank's) rights against it.

6. The SF Regulations implement the principal relevant aims of the SFD and Article 9(1) in relation to collateral security charges (in favour of CREST settlement banks) through:

(1) regulations 14(1)(d), (5) and (6) – which protect a contract for realising collateral security from the general distributional principle of insolvency law and, in particular, give priority to the settlement bank's claim over:

- the expenses of a winding-up;
- the expenses and remuneration of an administrator; and
- preferential debts - in a winding-up,

but note that as it appears that regulations 14(5) and (6) are intended to be read together and that paragraph (6) is only intended to apply in the circumstances mentioned in paragraph (5), a settlement bank's claim will only be paid out of the proceeds of its security in priority to the chargor's preferential claims and administration expenses if the chargor has first gone into administration – which is a highly unsatisfactory result as a settlement bank would almost certainly wish to enforce its security before the commencement of an administration;

(2) regulation 14(2)(c) – which prevents an insolvency office-holder from exercising his powers under the Insolvency Act 1986 to prevent or interfere with enforcement action under a collateral security charge;

(3) regulation 16(1) – which disapplies those provisions of the IA 1986 that allow a liquidator to disclaim onerous contracts and a court to rescind contracts in relation to a contract for the purpose of realising collateral security;

(4) regulation 16(3) – which disapplies section 127 of the IA 1986 (avoidance of property dispositions effected after commencement of winding-up) to the provision of collateral security and any contract for realising collateral security (or any disposition of property in pursuance of such a contract);

(5) regulation 17(1) – which prevents an order being made under sections 238 (transaction at an undervalue), 239 (preferences) or 423 (transactions defrauding creditors) IA 1986 in relation to the provision of collateral security and any contract for realising collateral security (or any disposition of property in pursuance of such a contract);

(6) regulation 19 – which disapplies the moratorium and related provisions under the administration regime in relation to a collateral security charge; and which disapplies section 127 of the IA 1986 in relation to a disposition of property as a result of which the property becomes subject to a collateral security charge.

7. The FCA Regulations, which implement the Directive in the UK, provide certain additional protections and other benefits to "security financial collateral arrangements". As HM Treasury is aware, there is considerable doubt in the financial markets as to the application of the FCA Regulations to floating charges - including system-charges and collateral security charges granted in favour of CREST settlement banks. As a result, there is a serious risk that, at least prior to crystallisation, such system-charges and collateral security charges do not benefit from the provisions of the FCA Regulations. Even if this view is subsequently found to be incorrect, the wide-spread legal uncertainty in the market on this point has undermined market confidence in relying on the FCA Regulations in relation to floating charges (including system-charges and collateral security charges).

8. The consequence is that, whether in fact or as a matter of perception, there is a serious risk that certain protections afforded to qualifying "security financial collateral arrangements" under the FCA Regulations do not extend to system-charges and collateral security charges. This is a counter-intuitive result and potentially undermines the principal aims of the Directive (which itself must be considered in the context of the framework established by the SFD). The irrationality of this result can be underscored when it is borne in mind that the principal aims of the Directive include:

(1) to build upon the framework established by the SFD so as to limit systemic risk inherent in payment and securities settlement systems and provide common rules in relation to collateral constituted to such systems (Recitals (1) and (3));

(2) to contribute to the integration and cost-efficiency of the financial market as well as to the financial stability of the financial system in the EU (Recital (3));

(3) to disapply provisions of insolvency law that inhibit the effective realisation of financial collateral or cast doubt on the validity of current techniques (such as provision of top-up collateral and substitution of collateral) (Recitals (5) and (16));

(4) to limit the administrative burdens relating to perfection of financial collateral (Recitals (9) and (10)) – but there must be an appropriate balance between market efficiency and the risk of fraud (Rectal 10)); and

(5) to provide for rapid and non-formalistic enforcement procedures in order to safeguard financial stability and limit contagion effects in the case of a default of a party (Recital (17)).

9. These aims are substantially similar, and must be considered in the context of, the aims of the SFD outlined in paragraph 4 above. It follows, we believe, that where HM Treasury has concluded that:

(1) whether in its current implementation of the Directive or in its prospective amendments to the FCA Regulations to ensure the aims of the Directive are fully implemented in the UK, certain protections should be afforded to "security financial collateral arrangements"; and

(2) the appropriate balance between market efficiency and risk of fraud would not be upset by extending those separate and additional protections to system-charges (under the FMI Regulations) and collateral security charges (under the SF Regulations),

then those protections should be so extended.

10. We would suggest that, as it is well recognised that market stability and systemic integrity are supported by the provision of system-charges and collateral security charges in favour of CREST settlement banks, there would be minimal fraud risk (in the manner contemplated by Recital (10) of the Directive) by extending the separate and additional protections of the Directive to such charges.

B. Gap analysis

11. Against the background provided by Section A of this Annex I, and utilising the methodology suggested by it, we consider that the following protections currently afforded (or potentially to be afforded) to "security financial collateral arrangements" under the FCA Regulations should be extended to system-charges and collateral security charges:

(1) the disapplication of section 4 of the Statute of Frauds (no action on a third party's promise), which may be relevant to "third party" charges granted by e.g. CREST nominees of a settlement bank's customer – see regulation 4(1) of the FCA Regulations;

(2) the disapplication of section 395 of the CA 1985[24] (registration of charges), and corresponding provisions relating to Scottish and Northern Irish charges – see regulations 4(4), 5 and 7 of the FCA Regulations;

(3) the disapplication of sections 10(1)(b) and 11(3)(c), 11(2), 15(1) and (2) of the IA 1986, which are not disapplied by regulation 19(1) of the SF Regulations but which may still have effect in relation to a number of categories of public-utility companies and building societies – see regulation 8(3) and (4) of the FCA Regulations;

[24] In this Annex, we refer to the relevant provisions of the Companies Act 1985. If amendments are to be made to the FCA Regulations or SF Regulations to extend the identified protections to system-charges and/or collateral security charges, then reference will need to be made to the corresponding provisions of the Companies Act 2006. It should also be noted that the disapplication of section 395 by regulation 4(4) is also taken to disapply the registration requirements under section 409 of the 1985 Act; and this has been previously confirmed by Treasury Solicitors.

(4) the disapplication of the moratorium that arises under a company voluntary arrangement and related provisions – see regulation 8(5) of the FCA Regulations;

(5) the disapplication of section 127 IA 1986 in relation to the disposition of the shares of an *issuer* subject to a compulsory winding-up (we understand HM Treasury may be minded to extend regulation 10(1) to cover a transfer of shares under an issuer's winding-up), and corresponding provisions under Northern Irish insolvency laws;

(6) the disapplication of section 88 IA 1986 in relation to a transfer of shares (in a voluntary winding-up), and corresponding provisions under Northern Irish insolvency laws – see regulations 10(2) and 11(2) of the FCA Regulations;

(7) the disapplication of section 176A IA 1986 (share of assets for unsecured creditors) – see regulation 10(3) of the FCA Regulations;

(8) the disapplication of section 245 IA 1986 (avoidance of certain floating charges) and the corresponding provision under Northern Irish insolvency law - see regulations 10(5) and 11(4) of the FCA Regulations;

(9) the priority given to the collateral-taker's claim over preferential debts and administration expenses – *and irrespective of whether the collateral-giver is in administration or whether it entered into administration before or after the enforcement of the security (see the concerns outlined in paragraph 6(1) above)*[25]; and

(10) the power to appropriate financial collateral upon enforcement – see regulations 17 and 18 of the FCA Regulations.

12. It is also the case that the SF Regulations do not currently provide clear protection in relation to a participant that is subject to a creditors' voluntary winding-up, but which was commenced as a members' voluntary winding-up – i.e. where there has been a conversion under sections 96 and 102 of the IA 1986 as a result of the liquidator's determination that the company is in fact insolvent. The definition of "winding-up" in regulation 2(1) of the SF Regulations expressly excludes a members' voluntary winding-up; and regulations 20(1)(b) and 22(2)(b) (and paragraph 5(4)(a) of the Schedule) might be taken to suggest that the protections afforded by the SF Regulations do not extend to a participant that is insolvent under a creditors' voluntary winding-up that commenced as a members' procedure. It would greatly assist market confidence in the SF Regulations if:

(1) it was clarified that references to "winding-up" included such a creditors' voluntary winding-up;

[25] The disapplication of section 196 of the Companies Act 1985 (as occurs in relation to "security financial collateral arrangements" under regulation 10(6) of the FCA Regulations) is particularly important to the CREST settlement banks. EUI and the CREST settlement banks have agreed certain "fast-track" realisation procedures, which are consistent with the requirements of the Uncertificated Securities Regulations and are designed to enable a settlement bank to take prompt enforcement action (with a view, in particular, to protect the settlement bank against losses that might otherwise arise as a consequence of falling market values affecting the charged CREST securities). These procedures are likely, however, to result in the settlement bank "taking possession" of the charged securities, prior to its enforcement action, for the purposes of section 196.

(2) transfer orders that enter the system before or on the day that the voluntary winding up was converted to a creditors' procedure are protected under regulation 20; and

(3) the relevant notification obligations under regulation 22(2) and paragraph 5 of the Schedule apply, in relation to such a procedure, to the liquidator and at the time the members' voluntary winding-up is converted to a creditors' voluntary winding-up.

Mark Evans
Travers Smith

APPENDIX II

CLLS PAPER SENT TO HM TREASURY IN AUGUST 2005

This Appendix has been removed for reasons of confidentiality