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H.M. Treasury: A Consultation on the Implementation of EU Directive 2009/44/EC on Settlement Finality and Financial Collateral Arrangements: August 2010

1. This is the response of the Financial Law Committee of the City of London Law Society to the Consultation Paper issued in August 2010 by H.M. Treasury on the implementation of EU Directive 2009/44/EC (the "**Amending Directive**").

2. Information about the City of London Law Society and the working party of its Financial Law Committee which produced this response is contained in Appendix A.

3. The consultation concerns laws throughout the UK, but our response (except for our reply to Question 3) is restricted to matters of English law.

4. Our response begins by summarising the conclusions that we have reached. It then explains why we consider that the very limited scope of the proposed amendments is an opportunity missed. Finally, we reply to the specific questions in the Consultation Paper.

5. Defined terms used in the Summary bear the meanings given to them later in this response.

22 October 2010

SUMMARY

Financial Collateral

1. We would urge H.M. Treasury to make changes to the law of the provision of financial collateral that go well beyond implementing the Amending Directive and extending the protections afforded by the 2003 Regulations to "system charges" and "collateral security charges".

2. We recommend that the protections afforded by the 2003 Regulations should be extended, not only to cover "system charges" and " collateral security charges", but also to cover all "market charges" within Part VII of the Companies Act 1989.

3. We propose that H.M. Treasury should extend the protections afforded by the 2003 Regulations to financial collateral arrangements which form part of a "wholesale transaction", whether or nor the financial collateral in question is in the possession or under the control of the collateral-taker.

4. Alternatively, or in addition, the 2003 Regulations should be amended to introduce a new definition of "control", which includes "negative control", thus reversing the *Gray* decision. Thought should be given as to whether it is possible to define "possession", even if the definition is restricted to specifying the sort of cases which the concept of "possession" should include.

5. These considerations have become more important now that the 2003 Regulations are to be extended to cover credit claims.

6. The 2003 Regulations should be amended to deal with the other problems identified in Appendix B and to make a small but important amendment to the definition of "credit claims".

7. If H.M. Treasury has any concerns about its *vires* to make these amendments under section 2(2) of the European Communities Act 1972, we would ask it to effect the proposed changes under its powers to make regulations about financial collateral arrangements contained in section 255 of the Banking Act 2009 (the **"2009 Act"**).

Settlement Finality

1. Similarly, we consider that it is essential to ensure that the 1999 Regulations remain fit for purpose with reference, in particular, to recent legislative, regulatory and market developments affecting the UK's systemically-important infrastructure.

2. There must be complete market confidence that any extension in the legislative protections given to "collateral security charges" is well-founded in law. We support the proposal that "collateral security charges" should benefit from the same disapplications of UK legislative and common law rules as "security financial collateral arrangements". However, we would not wish there to remain any doubt as to the effectiveness of the legislative route by which this has been achieved. For this reason, we have suggested that the relevant changes are effected either by using the powers under section 255 of the 2009 Act, or by making appropriate amendments to the 1999 Regulations themselves using the powers under section 2(2) of the European Communities Act 1972.

3. Changes to the regulatory landscape now mean that "payment institutions" are able to provide payment services which are broadly equivalent to those provided by banks and electronic money institutions. In order to ensure the efficient and effective provision of such services by these new payment service providers, these institutions will need to participate in designated payment systems. This will not be possible unless the 1999 Regulations recognise that such new providers are eligible to be "participants" of such systems. We therefore recommend that appropriate changes be made to the 1999 Regulations to allow for this.

4. Systemic issues created by "interoperable systems" mean that, if the 1999 Regulations are to continue to protect the integrity of the UK's designated systems in the manner contemplated by the Amending Directive, certain key provisions must apply not only in relation to participants of the designated system, but also the participants of interoperable systems in relation to those designated systems. We have suggested a number of drafting changes to achieve that objective.

5. In view of the absolute need to protect the stability of systems that are already designated, it is essential that the Amending Directive does not interrupt the seamless and continuous SFD protections for those systems. Accordingly, we would strongly recommend the inclusion in the Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements)(Amendment) Regulations 2010 (the **"Amending Regulations"**) of an appropriate "continuity" provision in similar terms to that set out in Article 10.2 of the SFD (as amended by the Amending Directive).

6. We believe that H.M. Treasury has the power to make all of these suggested changes to the 1999 Regulations under section 2(2) of the European Communities Act. This is because they would help to fulfil the key objectives of the SFD, as a minimum harmonization directive, with reference to the current and prospective payment and securities settlement models operating in the UK and elsewhere in the EEA. They would do this by: (a) reducing systemic, legal and other risks associated with participation in payment systems and securities settlement systems (see Recitals (1), (2) and (9) of the SFD); (b) contributing to the efficient and cost effective operation of cross-border payment and securities settlement arrangements (see Recital (3)); and (c) minimizing the disruption caused to the UK designated systems by the insolvency of a participant in that system or an interoperable system in relation to that system (see Recitals (4), (14a) and (22a)).

Timing

1. It is recognised that it is unlikely to be possible to make all of these changes before the Amending Directive is required to be implemented, that is, on or before 31 December 2010.

2. The Amending Regulations will, of course, introduce the provisions intended to implement the Amending Directive. We propose that they could without too much difficulty also deal with:

    (a) the three problems identified in Part I of Appendix B (Equivalent Financial Collateral, Appropriation and Banking Act 2009), all of which relate to the 2003 Regulations;

(b) the recognition of "payment institutions" as eligible to be participants of designated payment systems by amending the 1999 Regulations and certain other amendments; and

(c) the inclusion in the Amending Regulations of an appropriate "continuity" provision in similar terms to that set out in Article 10.2 of the SFD (as amended by the Amending Directive), which relates to settlement finality.

3. We have suggested amendments to the 1999 Regulations and the 2003 Regulations in Appendices E and F respectively in order to illustrate the sort of changes that might be required to deal with points (a) and (b) (but not point (c) because that would be dealt with in the Amending Regulations themselves). All of these changes would be implemented on or before 31 December 2010. Appendices E and F also contain some suggested additional drafting amendments.

4. The remaining changes recommended in this response would be implemented at a later date or dates. However, the fact that we have suggested that implementation should be delayed does not mean that the changes are any less significant or pressing; it simply means that they may require further discussion or that they can only be implemented using the powers contained in section 255 of the 2009 Act[1].

[1] Regulations made under section 255 require an affirmative resolution of both Houses of Parliament: see sub-section 256(1) of the 2009 Act.

5. **Scope of amendments to the Financial Collateral Arrangements (No. 2) Regulations 2003 (the "2003 Regulations")**

5.1 We note that H.M. Treasury do not propose to use the implementation process to make any changes to the 2003 Regulations beyond those required by the Amending Directive, with the possible exception of extending the protections afforded by the 2003 Regulations to "system charges" and "collateral security charges".

5.2 We think that this is an opportunity missed. Whilst, as the European Commission reported in 2006, Directive 2002/47/EC on financial collateral arrangements (the "**FCD**") has generally been a success, its implementation in the UK could have been much more successful if the 2003 Regulations had been amended to deal with certain problems which have arisen in practice and which we describe in this response.

5.3 By far the most serious problem is referred to in the discussion on floating charges in paragraphs 3.1 – 3.7 of the Consultation Paper and that is the difficulty of ensuring that floating charges on financial collateral (including, importantly, fixed charges on financial collateral which are recharacterised as floating charges) receive the benefits afforded by the FCD.

5.4 There are, however, other problems associated with the 2003 Regulations which could, if not rectified, affect the competitiveness of the UK as a financial centre. We wish to avoid a situation in which market participants choose to use other European jurisdictions and laws to implement financial collateral arrangements. We have listed some of these problems in Appendix B. Some of our members have noticed that since the Lehman collapse at the end of 2008 there has been a growing tendency to use security financial collateral arrangements in preference to title transfer financial collateral arrangements. The reason for this may be that with a security financial collateral arrangement the collateral-provider does not normally take a credit risk in relation to the collateral-taker. As nearly all of the problems identified in Appendix B relate to security financial collateral arrangements, it is becoming all the more important that these problems should be addressed. We would suggest that some of these problems (those described in Appendix B under the headings "Equivalent Financial Collateral", "Appropriation" and "Banking Act 2009") can be dealt with in the Amending Regulations (see amended draft 2003 Regulations set out in Appendix F). The remainder may have to be dealt with at a later stage.

5.5 However, the area that is most in need of clarification is the treatment of floating (including recharacterised fixed) charges.

5.6 The problem has its origins in the requirements of the FCD[2] that in order to be a "security financial collateral arrangement" the collateral-provider must "provide" the financial collateral by way of security in favour of, or to, the collateral-taker and a reference to "provide" means 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 of a person acting on the collateral-taker's behalf". This requirement is mirrored in the definitions of "security financial collateral arrangement" (paragraph (c)) and "security interest" (paragraph (d)) in the 2003 Regulations.

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[2] Articles 2.1(c) and 2.2 and Recital (9).

5.7 Ever since the 2003 Regulations came into force, legal practitioners have been concerned by the uncertainty of the "possession" or "control" requirement and, in any situation in which there was any conceivable doubt as to whether or not the requirement was satisfied, they have adopted the prudent position that it was not. This has meant that practitioners routinely register at the Companies Registry charges on financial collateral, even if they are expressed to take effect as fixed charges. It has also meant that any legal opinion given on the validity and enforceability of the security has been qualified to reflect the fact that the protections afforded by the 2003 Regulations might not be available.

5.8 It seems that the prudence shown by practitioners has proved to be justified. In *Gray & Ors v G-T-P Group Ltd Re F2G Realisations Ltd (in Liquidation)*[3], Vos J. held that a declaration of trust (recharacterised as a charge) did not constitute a "security financial collateral arrangement" under the 2003 Regulations so as to be exempt from registration.

5.9 The judge was quick to dismiss the concept of "possession": he adopted the statement made by Professor Beale, Bridge, Gullifer and Lomnicka in their book on the Law of Personal Property Security 2007 that under English law "possession" had no meaning in relation to intangible property[4]. We would question that proposition, even from a narrow English law perspective, because English law recognises that intangible property can be constituted in documentary form – for example, as bonds or other bearer securities which are capable of being "possessed" by way of security (e.g. in support of a pledge or legal mortgage). Such securities are sometimes referred to as "documentary intangibles". As "possessory" security interests fall within the scope of the FCD and the 2003 Regulations (see, for example, paragraphs (a) and (e) of the definition of "security interest" in regulation 3), it is clear that the "possession" concept has a role to play.

5.10 In many cases it is impractical for parties to arrange for "control" of the financial collateral to be vested in the collateral-taker, and given the uncertainty in the past over how to achieve effective "control" under the 2003 Regulations, many existing financial collateral structures have relied on "possession". If "possession" truly does have no meaning in relation to intangible property, one of the principal techniques for creating a security financial collateral arrangement in relation to book-entry securities and cash is ruled out completely. We do not believe that that result was intended when the 2003 Regulations were created. Furthermore, we do not believe that any policy dangers will arise if possession-based collateral arrangements are encouraged: in all cases where the collateral-taker has possession, the collateral-provider is "dispossessed" as required by the FCD (see e.g. Recital (10)) and there is no risk of creditors and counterparties being misled as to the apparent wealth of the collateral-provider.

5.11 It seems to us wrong for the judge to have applied an historical English law concept of "possession" when construing the 2003 Regulations, when he acknowledges that this would be an inappropriate road to follow when construing "control". The word should be given a European meaning as it stems from a European legislative instrument.

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3 [2010] EWHC 1772 (Ch).

4 Paragraphs 48 and 54 of the judgment.

5.12 The 2003 Regulations should therefore recognise that "possession" does have some meaning. It may not be appropriate or possible to give a comprehensive definition. However, we do think that it would be helpful to specify cases which "possession" was intended to include.

5.13 A majority of our Working Party thought that it should include a case in which securities and/or cash (that may fluctuate and change from day to day) are held to the credit of an account in the name of the collateral-provider with a bank acting as custodian where the bank is also the collateral-taker under a security financial collateral arrangement. The argument here is that the security does not give the impression of false wealth (even in the absence of any designation to the account) because any third party wishing to acquire an interest in the securities and/or cash would need to make enquiry of the custodian. The minority view, while accepting that "possession" should be given meaning in relation to book entry securities collateral (see e.g. regulation 19(4)(b) of the 2003 Regulations), is that the book entry securities collateral *itself* must be in the possession of the collateral-taker (e.g. by credit of the entry to an account in the name of the custodian as collateral-taker or its nominee, or by credit to a 'pledged-out' account). The minority concern is that such an arrangement is required to ensure that the collateral-taker's possession is truly "by way of security" (and not merely by way of custody) and to avoid "constructive" possession of the financial collateral remaining in the collateral-provider. We would welcome the opportunity of discussing these issues with H.M. Treasury, as well as how "possession" might be defined and what sort of cases that expression might cover. **The important thing for present purposes is that the rejection by Vos J in *Gray* of a "possession" test for intangible property should be reversed.**

5.14 However, it is in relation to the judge's construction of the meaning of "control" in the context of the 2003 Regulations that we have equal, if not more, concern.

5.15 The judge held[5] that "control" meant the legal right to deal with the collateral. It was not enough that the collateral-taker had, what the judge referred to as, "administrative control". He based his decision, in part at least, on the concept of "dispossession" embodied in the FCD.[6]

5.16 Thus on the facts of the particular case it was fatal that the collateral-provider had the legal right to use the money in the bank account until one of the events of default mentioned in the declaration of trust had occurred. This was the case even though the bank account was in the name of the collateral-taker and, presumably, as between the collateral-taker and the bank, the arrangement could have been terminated at any time and the bank would only recognise the collateral-taker as entitled to give it instructions in relation to the account.

5.17 Thus the judge moved close to the test laid down by the House of Lords in the *Spectrum* case[7] for determining whether a charge on book debts could be regarded as

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5 Paragraph 59 of the judgment. See also paragraphs 54 and 61.

6 Recital (10).

7 *National Westminster Bank PLC v Spectrum Plus Ltd* [2005] 2 AC 680.

fixed; namely, that what was required was something equivalent to a blocked account.[8]

5.18 The fact that the judge was eliding the "control" test for the purpose of the 2003 Regulations with the "control" test for the purpose of determining whether the charge should be characterised as fixed means that it is difficult to see any situation in which a floating charge could ever constitute a "security financial collateral arrangement", unless the sole reason that it was characterised as floating was the right of the collateral-provider to substitute collateral or to withdraw excess collateral. Indeed, this was recognised by the judge himself.[9]

5.19 Whether or not the judge was right in his construction of the "control" requirement, this does throw into stark relief the principal deficiency of the 2003 Regulations, a deficiency that is likely to become more acute now that the 2003 Regulations are to be extended to cover credit claims. Whilst we welcome the proposal to give specific protection to system charges and collateral security charges within the CREST system, we do not consider that this goes nearly far enough[10].

5.20 H.M. Treasury now have the power[11] to introduce legislation to extend the benefit of the FCD or FCD-like protections to all forms of security over financial collateral, whether fixed or floating. There may be good reason for removing the "control" requirement altogether in certain situations.

5.21 We appreciate that H.M. Treasury has concerns that extending the 2003 Regulations to all floating charges would raise questions about the appropriate level of protection for third parties, particularly unsecured creditors who (in the absence of a registration requirement) would be unaware that a floating charge had been created by the company.[12] Presumably, the concerns are all the greater now that credit claims are included as financial collateral.

5.22 We submitted a paper to H.M. Treasury in September 2007 suggesting that floating charges that did not satisfy the "control test", but which were granted as part of a "wholesale arrangement", might nevertheless be afforded the benefit of the FCD.

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8 See the speech of Lord Hope at paragraph 61 of *Spectrum* and paragraph 61 of the *Gray* judgment. Concern over the meaning of "control" is, of course, all the greater following *Spectrum* because of the risk that a charge purporting to be a fixed charge may be recharacterised as a floating charge over a wider range of asset types than just book debts (for example, a portfolio of securities where the collateral-provider wishes to be free to deal).

9 At paragraph 58.

10 In any event, for the reasons outlined in paragraphs 2.3 – 2.7 below, in order to avoid any legal uncertainty as to the power of H.M. Treasury to bring system charges and collateral security charges (as floating charges) within the scope of the 2003 Regulations under section 2(2) of the European Communities Act 1972, we would recommend that the relevant additional protections are extended to such charges either through use of the power in section 255 of the 2009 Act or by amendment to the 1999 Regulations themselves.

11 Section 255 of the 2009 Act.

12 Paragraph 3.3 of the Consultation Paper.

5.23 The relevant parts of that paper are set out in Appendix C, but you will note that we identified what might be the key elements of a "wholesale arrangement", as follows:

- the collateral-provider 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 Insolvency Act 1986 (the "**IA 1986**"); 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" (see definition in Appendix C).

5.24 Financial structures are not static. The "wholesale arrangement" exception which we suggested in 2007 was linked to the capital markets. It may be desirable also to include other arrangements of a wholesale nature such as a specialised financing provided through the loan markets of the kind referred to in Appendix 1 to our response to the Consultation Document "Proposals for a Restructuring Moratorium" issued by the Insolvency Service in July 2010 (the "**Moratorium Consultation Paper**"). We should be very happy to meet to discuss with you the scope of these proposed exemptions.

5.25 As an alternative to these proposed exemptions, or in addition to them, the 2003 Regulations could be amended so as to include a definition of "control".

5.26 "Control" might be defined so as to include "negative control" that is, 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 deal with the financial collateral until the occurrence of a specified crystallisation event (where the collateral-taker might take "positive control") would not mean that negative control did not exist). Such consent could take the form either of a consent given at the time of the relevant disposal or grant of a security interest or of a revocable standing consent which pre-defines the terms on which a collateral-provider can dispose of or grant a security interest in the financial collateral. The introduction of a simple contractual test for control would introduce much welcome *ex ante* certainty into this area. It would have to be recognised, however, that it would be open to an insolvency office-holder to argue in any given case that the contractual agreement had not been adhered to in practice and that no "control" existed.[13] The

[13] Lord Millet said in *Agnew and another v Commissioner of Inland Revenue and another* [2001] 2 AC 710, 730, paragraph 48, in the context of deciding whether a charge on book debts was a fixed charge or a

fact that the contractual restrictions could be overridden in this way would suggest that it might be desirable not only to provide an inclusive definition of "control" for the purpose of the 2003 Regulations, but also to include the "wholesale arrangement" exemption which would be available regardless of any control that was or might be exercisable by the collateral-taker.

5.27 We would urge H.M. Treasury to extend the categories of floating charge that might benefit from the FCD beyond the narrow category of system charges and collateral security charges within CREST and to include also "market charges" (including system charges) generally under Part VII of the Companies Act 1989. The reasons why this is considered important are set out in our September 2007 paper, extracts of which appear in Appendix C.

5.28 The introduction of the special exemption for wholesale transactions and/or the amendment to the definition of "control" could be dealt with at a later date, as could the amendments to the 2003 Regulations to deal with the problems listed in Part II of Appendix B.

5.29 We have suggested in Appendix F an amendment to the definition of "credit claims". Although this definition tracks the definition in the Amending Directive[14], it suffers from a flaw in that it does not allow claims held by a bank purchased in the secondary market to qualify. This surely cannot be right as the intention is to implement the recommendation of the European Central Bank that the pool of available collateral for Eurosystem Credit Operations should be increased and to benefit consumers and debtors by providing more intense competition and better availability of credit[15]. The importance of ensuring that credit claims are assignable is also recognised[16]. We therefore consider that this small but important amendment to the definition can readily be justified in terms of giving purposive effect to the Amending Directive.

2. Scope of amendments to the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (the "1999 Regulations")

2.1 If the 1999 Regulations are to remain an important tool in protecting the integrity and stability of the UK's financial markets, it is imperative that the Regulations remain responsive to systemic, legislative and regulatory developments affecting UK designated systems.

2.2 Since the original implementation of Directive 98/26/EC on settlement finality in payment and securities settlement systems (the **"SFD"**), there have been a number of such developments that now urgently need to be addressed in the 1999 Regulations. These developments are considered in more detail in paragraphs 2.3 to 2.24 below.

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floating charge, that "their Lordships would wish to make it clear that it is not enough to provide in the debenture that the account is a blocked account if it is not operated as one in fact." This would seem to indicate that a court might be prepared to recharacterise an arrangement under which "negative control" had been agreed as one under which no "control" for the purposes of the 2003 Regulations did, in fact, exist.

14 Article 2(5)(a)(ii).

15 Recital (5) of the Amending Directive.

16 Recital (6) of the Amending Directive.

(1) A mismatch in legislative protections

2.3 The implementation of the 2003 Regulations, subject to their addressing the points that we have outlined in paragraph 1 above, provide certain key protections to qualifying "security financial collateral arrangements" that are not currently extended to "collateral security charges" under the 1999 Regulations. This is an odd result and is difficult to justify on any rational policy basis.

2.4 In our 2007 paper to H.M. Treasury, the relevant extracts of which are set out in Appendix C to this response, we set out a "gap" analysis as to where the current protections afforded to "collateral security charges" fall short of those provided to "security financial collateral arrangements". We consider that the analysis is as relevant today as it was 3 years ago – indeed, even more so, as the values that are now passing through the CREST system materially exceed those passing through the system back in 2007 (see paragraph 3.5 of the Consultation Paper).

2.5 H.M. Treasury's proposals in section 3 of the Consultation Paper suggest that it is minded to extend FCD protections to "collateral security charges". For the reasons set out in our 2007 paper, we would strongly support that proposal. However, in view of the systemic significance of "collateral security charges", there must be no residual doubt as to the power of H.M. Treasury to effect such changes by amendments to the 2003 Regulations. In particular, as many "collateral security charges" operate as floating charges, in the light of the *Gray* decision there would remain material market concern (in the absence of the changes we have proposed in paragraph 1 above) as to whether financial collateral under a "collateral security charge" can properly be considered "provided" to the collateral-taker within the scope of Article 2.2 of the FCD. Any use of the implementing power under section 2(2) of the European Communities Act to make the required changes to the 2003 Regulations would, therefore, raise concerns that such changes were outside the scope of those mandated by the FCD.

2.6 We would suggest, therefore, that the required changes are made through regulations under section 2(2) of the European Communities Act 1972 – but by way of amendment *to the 1999 Regulations* in implementation of the SFD (as amended by the Amending Directive). There is no "control" requirement for "collateral security charges" under the SFD or the 1999 Regulations. On the other hand, the policy objectives at the basis of extending protections against insolvency and related matters to "security financial collateral arrangements" under the FCD apply equally to "collateral security charges" under the SFD - including the common aims for integration and cost-efficiency of financial markets and the stability of financial systems. On this basis, we suggest that in order to achieve the fundamental objectives of the SFD, it is in now appropriate to extend those protections to "collateral security charges" by way of corresponding amendments to the 1999 Regulations. This would have the additional benefit of ensuring that all relevant disapplications and other provisions applicable to "collateral security charges" can be found in one statutory instrument – rather than spread across both the 1999 Regulations and the 2003 Regulations.

2.7 In the alternative, if H.M. Treasury were to conclude that it would be undesirable to make material changes to the 1999 Regulations themselves, the changes might be effected to the 2003 Regulations in exercise of H.M. Treasury's powers to make

regulations under section 255 of the 2009 Act – which section is not subject to any "control" or other relevant restrictions on the regulation-making power in relation to financial collateral arrangements.[17]

2.8 In the longer term, it would be useful to ensure that there was overall consistency between the protection against insolvency risk provided by the 1999 Regulations, the 2003 Regulations and Part VII of the Companies Act 1989.

(2) Expansion of "payment service providers"

2.9 The implementation of Directive 2007/64/EC on payment services in the internal market (the **"PSD"**) was intended to establish a "modern and coherent legal framework for payment services… which is neutral so as to ensure a level playing field for all payment systems" (see Recital (4)). The PSD aims to encourage competition in payment services by allowing those services to be provided by "payment service providers" other than (and in addition to) banks and electronic money institutions – these are authorised, registered or EEA authorised "payment institutions" under the Payment Services Regulations 2009 (the **"PSRs"**). "Payment institutions" (like electronic money institutions) did not exist at the time of the adoption of the SFD. The Evaluation Report on which the Amending Directive was based preceded the adoption of the PSD by some 18 months[18]. This means that the Amending Directive itself lags behind structural developments that have since had a significant impact on European financial markets.

2.10 As recognised in Recital (16) of the PSD, "it is essential for any payment service provider to be able to access the services of technical infrastructures of payment systems" - subject to appropriate requirements to protect the integrity and stability of those systems. This objective is given substantive expression by the access requirements of Article 28 of the PSD, which is implemented in the UK through Part 8 of the PSRs.

2.11 Currently, these access requirements do not apply to designated payment systems (see e.g. regulation 96(1)(a) of the PSRs)[19]. However, payment institutions, and certainly those institutions that are authorised or registered to operate "payment accounts" (as defined by regulation 2(1) of the PSRs), are already providing payment services that are in substance identical or materially identical to those provided by banks and electronic money institutions. In order to provide those services efficiently and effectively to customers, we believe that there is or will become a clear need for such institutions to participate in at least some designated payment systems – whether as direct or indirect participants.

2.12 At present, however, such participation is generally prohibited under the rules of designated payment systems. This is because it is a condition to admission that applicants should be "participants" or "institutions" within the meaning given to those terms in regulation 2(1) of the 1999 Regulations. A "payment institution" under the PSRs does *not* fall within the current definition of these terms in the 1999

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17 See section 255(3)(b) of the 2009 Act.

18 "Evaluation report on the Settlement Finality Directive 98/26/EC" (27.3.2006).

19 Questions submitted to the European Commission under its "Your questions on the PSD" web-page clearly indicate that the current exclusion of designated systems from the access requirements of the PSD is causing issues for market participants – see e.g. questions ID 15, 134 and 923.

Regulations. The clear rationale for this eligibility requirement is to ensure that the protections given by the 1999 Regulations will be triggered in the event that insolvency proceedings are commenced against a participant. Operators of designated payment systems, and the Bank of England as overseer of such systems, are naturally opposed to the admission of any institution if the integrity and stability of the system would be affected by that institution's insolvency, because that institution is not of a type against whose insolvency a designated system is protected under the Regulations.

2.13 The result is, potentially, to defeat one of the key objectives of the PSD. In addition, it prevents structural steps to be taken that might avoid the concentration of risk in a small number of bank-participants in the UK designated payment systems. These points raise concerns that the current UK implementation of the SFD may not, in fact, contribute "to the efficient and cost effective operation of cross-border payment" arrangements in the EEA (see Recital (3) of the SFD) or to "the reduction of systemic risk" (see Recital (9)).

2.14 We would suggest that the opportunity should be taken to remove this anomaly as far as UK designated systems are concerned. This might be achieved in one of two ways. The preferred solution will depend upon the degree of control that H.M. Treasury would wish to reserve to the Bank of England (with particular regard to its financial stability function) to determine whether, on grounds of systemic risk, it is appropriate to permit admission of "payment institutions" (or a class of them) to participation in a particular designated system. The two routes are:

(1) to include "authorised payment institutions", "registered payment institutions" and "EEA authorised payment institutions" (each as defined in regulation 2(1) of the PSRs) into the definition of "institution" in the 1999 Regulations – or at least any such institution that is permitted to operate "payment accounts" under the PSRs (which operate in much the same way as a current account maintained with a bank); or

(2) to remove the current restriction in regulation 8(1)[20] of the 1999 Regulations (which allows a designating authority to "treat" *any* undertaking as an "institution" where required on grounds of systemic risk), which presently limits the operation of that provision only to systems through which "security transfers orders" enter (and not "payment transfer orders") – if this regulation were applied to both payment and securities settlement systems, the Bank of England (as designating authority for payment systems) would have the same power as the FSA (as designating authority for securities settlement systems) to treat payment institutions (or a designated class of them) as participants in a particular designated payment system if such treatment is justified on grounds of systemic risk.

2.15 The result of taking either of the actions suggested in paragraph 2.13 would be to allow an operator of a designated payment system, where it felt it appropriate to do so and where the protections of the 1999 Regulations are extended to such participants,

[20] This restriction derives from Article 2(b) of the SFD. However, as the SFD is a minimum harmonization directive, we believe that there is no *vires* concern if H.M. Treasury accept the analysis that to give the Bank of England (as designating authority) powers under regulation 8 (and, therefore, regulation 9) would enable it to take steps to enhance the integrity and stability of the UK's financial system consistent with the fundamental objectives of the SFD.

to admit "payment institutions" (or a specified class of such institutions) to participation in its system. This might be either as a direct participant or, at the further election of the Bank of England under regulation 9(1) of the 1999 Regulations, as an indirect participant. The operator of a designated payment system would be able to do this without any concern that the admission of such an institution might, by virtue of that institution's insolvency, adversely affect the integrity or stability of the system.

2.16 It would, of course, remain open to the operator of a designated payment system to determine that there are other objective, proportionate and non-discriminatory reasons why it should not admit "payment institutions" (or a class of them) to participation in its system. However, that decision should not rest solely upon a failure of the 1999 Regulations to deal with a clear and apparent lacuna in its protections against the insolvency of institutions that wish to provide payment services on a level playing field with bank providers.

(3) Growth of intermediation and indirect participants

2.17 We welcome the proposed expansion of the "indirect participant" concept: (a) to cover indirect participants in both payment and securities settlement systems, and (b) to allow for a wider class of such indirect participants beyond credit institutions. However, we are concerned that in certain systems, including the CREST system operated by Euroclear UK & Ireland Limited (**"EUI"**), it may simply be impracticable for the operator at any one time to know the identity of all "indirect participants" that may access the system under arrangements with direct participants – at least, outside the operation of the system's "default arrangements". A CREST member may, for example, act on behalf of a large number of clients; and the identity and size of the CREST member's client base will fluctuate from time to time. On the other hand, as the CREST member will or may be holding CREST securities the beneficial title to which is vested in its clients, the insolvency of any such client may affect the integrity of CREST settlement. This would be the case in relation to any securities transfer order entered into the system by the CREST member on behalf of the insolvent client.

2.18 Designated systems, such as CREST, would clearly benefit from the potential protections afforded by the 1999 Regulations against the insolvency of indirect participants. However, there is a requirement in paragraph (b) of the proposed definition of "indirect participant" that the identity of such an indirect participant "is known" to the system operator. This is likely to mean, in practice, that the potential protections will not be available unless there is a flexible and practical approach to this "known identity" requirement. The identity of an insolvent indirect participant is only likely to become known to the operator of a system, such as EUI in relation to CREST, as part of the "default arrangements" for that system. EUI, for example, requires a CREST member acting on behalf of a third party to notify it immediately of any event (such as the insolvency of the member's client) that might affect the integrity of CREST settlement. As part of this process, the identity of the underlying client would be disclosed to EUI. However, it would not be disclosed prior to the operation of the relevant "default arrangements" in relation to the relevant CREST member.

2.19 This particular circle could be squared if it were made clear in the 1999 Regulations that the requirement to know the identity of an indirect participant can be satisfied if

the identity is made known to the system operator under its "default arrangements". We have suggested in Appendices D and E some draft changes to the 1999 Regulations to accommodate this.

(4) *Increase in links between systems*

2.20 It is clear from the amendments made to the SFD by the Amending Directive (see e.g. the changes made to Articles 7 and 9 of the SFD) that a UK designated system is intended to receive protection not only from the insolvency of one its own participants, but also from the insolvency of a participant in an interoperable system in relation to that designated system. However, there are a number of key definitions and provisions in the 1999 Regulations which, as currently drafted, are specifically limited in their application to a "designated system" – *that is a system designated under the 1999 Regulations* (see the definition of "designated system" in regulation 2(1)).

2.21 The result, in the absence of appropriate drafting changes, is that the protections intended to be given to systems in respect of their arrangements with an interoperable system are not achieved by the 1999 Regulations. For example, the present definition of "institution" refers to bodies which participate in a "designated system" (i.e. a system under the Regulations and not a system designated under the laws of any other member state). As such, those provisions of the 1999 Regulations that apply on the insolvency of an "institution" (or "participant" to the extent it cross-refers to an "institution") would not be triggered by (and the designated system would not be protected against) the invalidating effects of UK insolvency law to the extent they are relevant upon the insolvency of a participant in an interoperable system (designated in another EEA state) with which the UK designated system has a relevant link.

2.22 In order to avoid this unintended result, and to ensure that the 1999 Regulations achieve the objectives of the Amending Directive in relation to interoperable systems, various definitions and other provisions in the 1999 Regulations need amendment. We have suggested some drafting changes in Appendices D and E to achieve this.

Continuity provisions

2.23 It is essential, in the interests of financial stability, that there should not be any legal uncertainty as to the SFD protections afforded to *existing* designated systems; or to transfer orders that entered a designated system before the amendments to the 1999 Regulations take effect, but are processed and settled after those amendments take effect. The 1999 Regulations, as amended, must provide continuous and seamless protection for such systems and transfer orders. It was for this reason that the draftsman of the Amending Directive inserted Article 10(2) of the SFD (as amended). We would strongly support the inclusion of a similarly clear and robust "continuity" provision in the Amending Regulations.

Other drafting suggestions

2.24 We have also set out in Appendix D to this response some further drafting suggestions for the Amending Regulations. The explanations for the changes, if not responding to the points in the preceding paragraphs of this paragraph 2, are outlined next to the

proposed change. Appendix E sets out the 1999 Regulations with these drafting suggestions included.

3. Questions raised in the Consultation Paper

3.1 We now turn to the specific questions raised in the Consultation Paper.

3.2 These were divided in the Consultation Paper into three parts: amendments relating to settlement finality, amendments relating to financial collateral and further possible changes for discussion. We adopt the same divisions in our response.

Amendments relating to Settlement Finality

Question 1

What costs (size and nature) will system operators need to incur in order to achieve compliance with the requirement to coordinate their rules on irrevocability?

This must, ultimately, be a question that can only properly be answered by the system operators of the designated systems concerned. However, in putting in place contractual or other arrangements with another system to support the cross-system execution of transfer orders, we would expect a designated system and the linked system to be highly sensitive to the systemic, legal and other risks created by any failure to co-ordinate their respective rules on the moment of entry of a transfer order and its irrevocability. This would not only be a business and operational imperative, but also a key regulatory consideration in view of the potential high impact on the stability and smooth operation of the financial markets if there were to be any material uncertainty on these points in the event of the insolvency of a major participant. As such, we believe that such issues would be identified and resolved in the natural course of the development of the arrangements that underpin the link between the two systems concerned. Further, as the issue is primarily a contractual one (resolved through the rules of the respective systems concerned), we would not expect there to be any material costs associated with the need to ensure compliance with this co-ordination requirement.

Question 2

Do you agree that electronic money institutions should be brought within the scope of the Settlement Finality Regulations?

Yes, we do. However, for the reasons explored in paragraphs 2.9 to 2.19 of this response, we also believe that "payment institutions" (or, at least, payment institutions that are permitted to operate "payment accounts" under the PSRs) should be brought within scope of the Settlement Finality Regulations. In the alternative, regulation 8(1) of the 1999 Regulations should be amended to enable the Bank of England to "treat" payment institutions as "institutions"/"participants" of a designated payment system, if the Bank considers that this is warranted on grounds of systemic risk.

The failure to allow for one or other of these options would, potentially, materially hinder the promotion of competition between payment service providers. It would also represent a missed opportunity to promote stability in the financial markets by ensuring that structural measures can be taken to prevent the concentration of risk in a small number of market participants as members of our designated payment systems.

Amendments relating to Financial Collateral

Question 3

Do you have any comments on draft regulation 4 of the amending SI?

Regulation 4 of the 2003 Regulations relates to the registration of charges: Scotland.

While the detailed language should be considered with Scots lawyers, it seems to us that a disapplication of this legislation is necessary to ensure compliance with the UK's Community

obligations and the requirements of the Scotland Act with regard to European Community law. We therefore suggest that a security financial collateral arrangement which is created or takes effect as a floating charge be excluded from the requirement for registration under Part 2 of the B&D Act. We understand that it would also be necessary to provide, for Scots law purposes, that such a charge would be treated as created on the date it is executed and delivered, since Part 2 currently contemplates that a floating charge will be created only on the date it is registered.

Question 4

Do you agree that provision should be made to ensure that foreign insolvency orders or acts cannot be recognised or given effect to by the UK courts in circumstances where an equivalent order or act could not be made or done by a court in the UK because of the protections contained in the 2003 Regulations?

Paragraph 2.19 of the Consultation Paper seems to assume that the collateral-provider is a foreign entity and that the bankruptcy of the entity takes place in the jurisdiction of incorporation. It suggests that an English incorporated entity can only be subject to insolvency proceedings in England and that an entity incorporated in a foreign jurisdiction can only be subject to insolvency proceedings in that foreign jurisdiction.

This is, of course, very far from being the case. The English courts have jurisdiction to wind up a foreign incorporated entity as an "unregistered company",[21] but it will only do so if there is sufficient nexus between the foreign entity and England – for example, if the unregistered company has (or had) a place of business or branch office or has assets within the English jurisdiction.[22]

Equally, the English courts have jurisdiction to make an administration order in respect of a company not incorporated in an EEA State but having its centre of main interests in a Member State other than Denmark.[23]

No doubt the courts of most foreign jurisdictions have the power in appropriate cases to make orders subjecting entities incorporated in England to foreign insolvency proceedings.

The question is therefore where any entity, wherever incorporated, is subject to foreign insolvency proceedings, whether in the circumstances described or otherwise, insolvency orders or acts of the courts of the foreign jurisdiction should not be recognised or given effect to by the UK courts.

The question is a topical one. In a recent case[24], it is being argued that the UNCITRAL Model Law (applied in England by the Cross-Border Insolvency Regulations 2006) confers jurisdiction upon the English courts to give effect to foreign bankruptcy law so as to invalidate a transaction governed by English law and that would otherwise be valid under English law.[25]

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21 Part V of the IA 1986.

22 *Banque des Marchands de Moscou (Koupetschesky) v Kindersley* [1951] Ch. 112

23 Paragraph 111(1A) of Schedule B1 to the IA 1986.

24 *Perpetual Trustee Co. Ltd v BNY Corporate Trustee Services Ltd and another* [2009] EWHC 1912 (Ch.); [2009] EWCA Civ. 1160 (CA).

25 See paragraph 61 of the judgment of the Chancellor at first instance.

In our view, it would be highly undesirable if a financial collateral arrangement which is governed by English law and has the protection contained in the 2003 Regulations could be invalidated by an order or act of a foreign court in an insolvency proceeding of one of the parties in circumstances in which there could not have been an equivalent order or act if the insolvency proceeding had taken place in England.

We do not believe that this is the effect of the Cross-Border Insolvency Regulations 2006 where the relief available on recognition of a foreign main or non-main proceeding is defined by reference to British insolvency law.[26]

On the other hand, section 426 of the Insolvency Act 1986 does confer jurisdiction for an English court to grant assistance where this is requested by a foreign court in a relevant country or territory in circumstances in which the English court would not otherwise have had jurisdiction to do so.[27] However, it is thought unlikely that the discretion[28] would be exercised in such a way that would allow a financial collateral arrangement to be set aside under foreign insolvency law in circumstances in which it would be valid and effective in an English insolvency proceeding.

Even though it is therefore unlikely that an English court would recognise or give effect to an order or act made by a foreign court which would allow a financial collateral arrangement to be set aside or prejudiced in circumstances in which there could have been no equivalent order or act in proceedings in the UK, we nevertheless consider that it would be prudent to make express provision in the 2003 Regulations preventing this from happening.

The proposed new Regulation 15A set out in the Amending Regulation, which seems to be closely modelled on Section 183 of the Companies Act 1989 (providing a similar protection in relation to foreign insolvency proceedings that might affect the provisions of Part VII of that Act), seems to cover the point adequately, although there are a couple of refinements that H.M. Treasury may wish to make.

In relation to Regulation 15A(2), H.M. Treasury may wish to add a proviso to the effect that, in deciding whether the making of the order or the doing of the act would be prohibited by Part 3 of the Regulations, regard shall be had to the substantive effect of the order or act and not its procedural form.

The other refinement that could be made is to make it clear that Regulation 15A is subject to the insolvency law of any other EU Member State that under Community law takes precedence. For example, if a bank supervised in Ireland were to be subject to reorganisation proceedings there, Irish insolvency law would have to be recognised in the UK as applicable by virtue of the implementation of Directive 2001/24/EC on the reorganisation and winding up of credit institutions. In such case, Regulation 15A could not limit the jurisdiction of the English court to give effect to a letter of request from the Irish court (although it would, of course, be likely that Irish insolvency law would recognise any financial collateral arrangement entered into under English law).

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[26] See, for example, Articles 20 and 21 of the Model Law. Article 23 allows the English court to make an order under certain provisions of British insolvency law for the avoidance of antecedent transactions.

[27] For example, the English court in *Re Dallhold Estates (UK) Pty Ltd* [1992] B.C.C. 394 at the request of an Australian court made an administration order in respect of a foreign company where under English law there would otherwise have been no jurisdiction to do so.

[28] *Hughes v Hannover – Ruckversicherungs A.G.* [1997] B.C.C. 921

If H.M. Treasury wished to refine the wording of the proposed new Regulation 15A in either of the ways set out above, we would be happy to suggest the drafting amendments that could be made.

Question 5

Do you agree that credit claims should not be exempted from the protections of the FCD where the debtor is a consumer or small business?

We agree that the option should not be exercised.

The FCD is intended to confer protections upon the collateral-provider and the collateral-taker under a financial collateral arrangement; the status of the debtor as a consumer or small business really has no relevance.

Moreover, we agree with H.M. Treasury that credit claims where the debtor is a consumer or small business are already being used as financial collateral, for example, in residential mortgage-backed securities and credit card securitisation transactions. If these transactions can be made more robust, this should assist in providing liquidity in the consumer and small business lending market.

Further possible changes for discussion

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?

We have already indicated[29] that we welcome this proposal, although we do not consider that the proposal goes nearly far enough[30]. We have suggested that all charges which form part of a "wholesale arrangement" should be brought within the scope of the 2003 Regulations or, alternatively, that a new and broader definition of "control" should be included. We have also suggested[31] that "market charges" generally (including system charges) under Part VII of the Companies Act 1989 should be included.

The reasons why it would be appropriate specifically to include collateral security charges and market charges generally (including system charges) within the scope of the 2003 Regulations are set out in the Consultation Paper; and were supported in the paper that we provided to H.M. Treasury in 2007 (the relevant extracts of which are set out in Appendix C to this response).

In addition, it should be noted that H.M. Government has already recognised that it is appropriate to include special safeguards for such charges in, for example, the 1999

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29 Paragraph 1.19.

30 We have also indicated, for the reasons outlined in paragraphs 2.3 to 2.7 of this response, that in the interests of legal certainty we would prefer H.M. Treasury to effect these changes by either: (a) making the required amendments to the 1999 Regulations utilising its powers under section 2(2) of the European Communities Act 1972; or (b) bringing "collateral security charges" within scope of the 2003 Regulations by utilising its powers under section 255 of the 2009 Act.

31 Paragraph 1.26.

Regulations, the Financial Markets and Insolvency Regulations 1996 (the "**FMI Regulations**") and section 72F of, and Schedule A1 to, the IA 1986.

It has to be recognised that, in view of the *Gray* decision, the "possession" or "control" test imposed by the 2003 Regulations may not be satisfied. Nevertheless, the fundamental aims of market stability, integrity and confidence suggest that this is just the sort of situation in which the FCD was intended to provide protection.

It is important that the protection is not confined to "system charges" in favour of CREST settlement banks (see paragraph 3.4 of the Consultation Paper). It should also cover any "collateral security charge" for the purpose of the 1999 Regulations where collateral security charges are taken for the purpose of securing rights and obligations arising in connection with other designated systems such as LCH.Clearnet, BACS, CHAPS, CLS and Faster Payments Service as the systemic integrity and market efficiency considerations apply equally to such other collateral security charges. In addition, collateral security charges which are given to a central bank for the purposes of securing rights and obligations in connection with its operations in carrying out its functions as a central bank should be covered.

Accordingly, all system charges and collateral security charges should be brought specifically within the scope of the 2003 Regulations (or otherwise have the relevant protections extended to them).

Question 7

Would you support the extension of the 1999 regulations to cover third country settlement systems? If so, what criteria should govern which systems are protected?

Yes, we would support the extension of the 1999 Regulations to cover qualifying third country settlement systems. In order for this extension to have effective, practical operation it would be necessary (in our view) for the laws and rules that govern transfer orders that enter such third country systems to approximate to the laws and rules that govern transfer orders that enter systems designated under the SFD. There would also need to be absolute certainty in the markets as to which third country systems "qualify" for this purpose under the 1999 Regulations at any on time.

At a minimum, therefore, the third country laws and rules would need to define or otherwise provide for: (a) concepts of "system", "transfer order" and "governing law" that correspond to those used in the SFD; (b) the moment at which a transfer order is treated as having entered a system; and (c) the moment at which such an order is treated as irrevocable. Article 27 of the Convention on Substantive Rules regarding Intermediated Securities (the **"Geneva Securities Convention"**) provides an example of how laws similar to those contained in the SFD might come to be adopted in third country jurisdictions.

The interests of certainty would, in our view, require some form of "recognition" to be given to such third country systems that satisfy these minimum requirements. This should be a function performed by the relevant UK designating authority. In the interests of trying to encourage as broad and effective scheme of recognition as possible for UK designated systems, we would favour requiring "mutuality" of protections for our systems to be an additional requirement for recognition of any such third country system.

H.M. Treasury might also consider whether additional qualifying criteria should be satisfied before the UK designating authority "recognises" a third country system – such as, the designating authority must determine that recognition is appropriate on systemic grounds and/or that there are co-operation arrangements in place that allow for the exchange of information with the third country designating authority. A list of recognised third country systems should be retained and made publicly available by H.M. Treasury and/or the relevant designating authority.

APPENDIX A

INFORMATION ABOUT THE CITY OF LONDON LAW SOCIETY

The City of London Law Society ("**CLLS**") represents approximately 12,000 City lawyers, through individual and corporate membership, including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, payment systems and securities settlement systems often in relation to complex, multi-jurisdictional legal issues.

The CLLS responds to Government consultations on issues of importance to its members through its 17 specialist Committees. A working party of the CLLS's Financial Law Committee, made up of solicitors who are experts in their field, have prepared the comments contained in this response.

The members of the Working Party are:

Robin Parsons, Sidley Austin LLP (Chairman of the Working Party)
Dorothy Livingston, Herbert Smith LLP (Chairman of the Financial Law Committee)
Geoffrey Yeowart, Hogan Lovells International LLP (Deputy Chairman of the Financial Law Committee)
Mark Evans, Travers Smith LLP
Richard Levitt, Slaughter & May
Guy Morton, Freshfields Bruckhaus Deringer LLP
John Naccarato, CMS Cameron McKenna LLP
Paul Lewis, Linklaters LLP
Dermot Turing, Clifford Chance LLP

APPENDIX B

OTHER PROBLEMS ASSOCIATED WITH THE 2003 REGULATIONS

PART I – PROBLEMS TO BE DEALT WITH BEFORE 31 DECEMBER 2010 BY THE AMENDING REGULATIONS

1. Equivalent financial collateral

There is a need to amend paragraph (d) of the definition of "security interest" and paragraph (c) of the definition of "security financial collateral arrangement".

A right of substitution is a key feature of most transactions involving security over financial collateral, but the requirement that only "equivalent financial collateral" (as defined) can be substituted effectively means that none of these transactions will benefit from the protections afforded by the 2003 Regulations. The requirement that only financial instruments "of the same issuer or debtor, forming part of the same issue or class and of the same nominal amount, currency and description" can be substituted makes a commercial nonsense of the right of substitution. In commercial terms, a right of substitution must by definition involve different securities.

The requirement under the SFD is not for substitution of "equivalent securities"; it is for substitution of securities of "substantially the same value" – see Article 8(3)(b) and Recital (16) of the FCD.

For derivatives counterparties required to collateralise substantial derivative exposures, a right to substitute different securities is a key feature. This is because it enables the derivatives counterparties to minimise the cost to them of providing that collateral - as they can then post whichever collateral is the cheapest for them to obtain (or finance) at the relevant time. Under the 2003 Regulations, derivatives counterparties have no comfort that such an arrangement would constitute a financial collateral arrangement. As a result, a number of derivatives counterparties have established their credit support arrangements under the laws of other European jurisdictions. The collateralisation operations of derivatives counterparties represent one of the most significant, and systemically important, uses of financial collateral. For the 2003 Regulations to impair the ability to establish such arrangements under English law makes the UK less competitive than other European jurisdictions and for no apparent purpose.

We have suggested wording to illustrate the sort of changes that might be required to deal with this problem in Appendix F. In our view, the definition of "equivalent financial collateral" needs to be retained in the 2003 Regulations because it is appropriate in other contexts.

2. Appropriation

The remedy of appropriation is only available "[w]here a legal or equitable mortgage is the security interest created or arising under a security financial collateral arrangement" (Regulation 17 of the 2003 Regulations).

Thus, read literally, there is no right of appropriation where the security interest is not a mortgage but a charge. This literal approach is fortified by looking at other

provisions of the 2003 Regulations that distinguish between a mortgage and a charge making it clear that the draftsman intended that Regulation 17 should only apply to a mortgage; for example, the definition of "security interest" in Regulation 3 includes a mortgage, a fixed charge and a floating charge in separate categories.

Regulation 17 may have been limited in this way because the remedy of foreclosure is only available to a mortgagee and not a chargee[32]. In legal theory, a creditor with the benefit only of an equitable charge has no interest in the charged property and no right to possession or foreclosure. Since an equitable charge transfers no property to the chargee, the extinction of the chargor's equitable right to redeem, which is all that foreclosure or appropriation achieves, is not enough to vest any interest in the charged assets in him. Notwithstanding that the remedy of foreclosure is limited in this way, there is no reason why the remedy of appropriation needs to be so limited. It would be quite possible for the 2003 Regulations to extend the remedy to chargees. The restrictive approach of Regulation 17 is certainly not required by the FCD, Article 4 of which requires Member States to ensure that, on the occurrence of an enforcement event, the collateral-taker shall be able to appropriate the financial collateral subject to a security financial collateral arrangement whatever form that security takes.

In our view, there would be practical benefits in extending the remedy or appropriation to chargees.[33]

We therefore suggest that the 2003 Regulations should be amended so as to allow a chargee as well as a mortgagee to have the remedy of appropriation where this has been agreed by the parties to the security financial collateral arrangement. In the case of a charge the Regulations should specifically provide that at the moment of appropriation the entire legal and beneficial interest or the chargor should pass to the chargee. We have suggested wording to illustrate the sort of changes that might be required to deal with this problem in Appendix F.

3. Banking Act 2009

Certain provisions of the Insolvency Act 1986 are disapplied by the 2003 Regulations in relation to security financial collateral arrangements and by the 1999 Regulations in relation to transfer orders effected through a designated system and collateral security.

It is clear that these disapplications apply in "conventional" insolvency proceedings such as winding-up or administration, but it is less clear that they apply where the

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32 *Re Owen* [1894] 3 Ch 220; Fisher and Lightwood, Law of Mortgages (12th Ed. 2006) Note 9, para 32.3. See more generally, "The remedy of appropriation under a share mortgage", Lord Millett, Law and Financial Markets Review, July 2008, p.333.

33 It is sometimes preferable for a lender to take security in the form of a charge rather than in the form of a mortgage. In *Re Charge Card Services Limited* [1987] Ch 150, Millett J (as he then was) held that it was a conceptual impossibility for a party to take security over its own obligation (as, for example, where a bank takes security from its customer on a deposit held with it). This was because the taking of security would involve a reassignment back to the security-taker of its own obligation, which would have the effect of discharging that obligation. Although the view that was taken in the *Charge Card* case was disapproved by the House of Lords in *Re Bank of Credit and Commerce International SA (No. 8)* [1998] AC 214, Lord Hoffmann in the leading speech only referred to charges and not mortgages. For that reason, where security is being taken by a bank from its customer on a deposit made by the customer with that bank, most practitioners would draft the security as a charge rather than as a mortgage.

collateral provider or participant is subject to bank insolvency or bank administration proceedings under the Banking Act 2009.

We recommend that the 2003 Regulations and the 1999 Regulations should be amended to deal with this point.

We have suggested wording to illustrate the sort of changes that might be required to achieve this in Appendices E and F.

Afternote: it appears that this issue has already been addressed in SI 2009 No. 317.

If special insolvency regimes are to be introduced for investment firms as a result of the recent consultation[34], it may be necessary to introduce further changes to the 2003 Regulations and the 1999 Regulations.

PART II – PROBLEMS TO BE DEALT WITH AFTER 31 DECEMBER 2010

4. Contractual set-off

Contractual set-off is a well recognised and widespread method of taking cash collateral in the UK. To include other forms of cash collateral within the 2003 Regulations (such as netting and security interests on cash), but not contractual set-off, is illogical and is unnecessarily increasing the complexity and costs of entering into financial transactions.

We understand that this point was not dealt with in the 2003 Regulations because of concerns on *vires*. That difficulty has now been removed with the enactment of section 255 of the Banking Act 2009.

5. Close-out netting

Regulation 12 of the 2003 Regulations provides that (with certain exceptions) a close-out netting provision should take effect in accordance with its terms.

The rationale for this provision is set out in preamble (14) to the FCD:

"Sound risk management practices commonly used in the financial markets, should be protected by enabling participants to manage and reduce their credit exposure arising from all kinds of financial transactions on a net basis, where the credit exposure is calculated by combining the estimated current exposures under all outstanding transactions with a counterparty, setting off reciprocal items to produce a single aggregate amount that is compared with the current value of the collateral".

Where a party enters into a transaction or series or transactions, it is not consistent with the objective of risk management that set-off should occur automatically when its counterparty enters into an insolvency proceeding. It is for that reason that it is common to provide, for example, in the schedule to an ISDA Master Agreement, that Automatic Early Termination should not apply.

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[34] "Establishing resolution arrangements for investment banks", H.M. Treasury 16 September 2010.

There is concern amongst practitioners that, notwithstanding Regulation 12, automatic set-off under Rules 2.85 or 4.90 of the Insolvency Rules 1986 (the "**IR 1986**") will occur if notice is given by the administrators of the counterparty of their intention to make a distribution or if an order is made for the winding-up of the counterparty.

This may well defeat the intentions of the parties, particularly if they have made an election to exclude Automatic Early Termination, with the result that the close-out netting provision has not, for all practical purposes, taken effect in accordance with its terms. The right of the Non-defaulting Party to select the time at which Early Termination occurs is regarded as commercially significant and important for the management of risk.

In our view, to give effect to the purpose of the FCD and allow the parties to manage their risk on a proper basis, the automatic set-off provisions in the IR 1986 should be disapplied in their entirety.[35]

A further concern arises with Regulation 12(2), which states that "[p]aragraph (1) shall not apply if at the time that a party to a financial collateral arrangement…[was aware of certain events]." Read literally, this introductory wording can be interpreted as *invalidating* a close-out netting provision if the party was aware of those events. We do not believe this is the correct reading of Regulation 12(2), the purpose of which is simply to remove the statutory safe-harbour for close-out netting provisions. If the provision is able to stand on its own feet without the benefit of the safe-harbour, we consider that Regulation 12(2) should not operate so as to remove that effectiveness. To do so would be inconsistent with policy and Article 7 of the FCD. In our view, the introductory words of Regulation 12(2) should be modified so as to clarify that close-out netting provisions which are valid without the protection of Regulation 12(1) remain so.

There is one further part that needs to be borne in mind concerning Regulation 12. In its paper of November 2007, the Financial Markets Law Committee recommended that the cut-off times set out in Rule 2.85(2) of the IR 1986 be amended so that debts incurred after the commencement of administration but before the administrator gave notice of intent to make a distribution to creditors (pursuant to Rule 2.95 IR 1986) should no longer be excluded from statutory set-off. If Rule 2.85(2) is amended in this way, it may be necessary or desirable to make consequential amendments to Regulation 12(2).

6. Preferential debts

Regulation 10(6) of the 2003 Regulations disapplies section 754 Companies Act 2006 (preferential creditors to have priority over a floating charge where possession is taken), but the Regulations do not for same reason disapply the equivalent provisions where a receiver is appointed (section 40 IA 1986) or where there is a winding-up (section 175 IA 1986).

We can only assume that the omission is inadvertent. We think that it should be rectified.

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[35] *Regulation 12(4) only disapplies Rules 2.85(4)(a) and (c) and 4.90(3)(b) of the IR 1986, which does not deal with the problem.*

7. Administrator's and liquidator's remuneration, expenses and liabilities and moratorium expenses

Regulation 10(3) of the 2003 Regulations disapplies section 176A IA 1986, (prescribed part of a company's assets to be made available to unsecured creditors).

It is right that this provision should be disapplied because the commercial expectation of a bank making available a facility upon the security of financial collateral is that the bank would not be required to share the net proceeds of enforcement of the security with unsecured creditors.

By the same reasoning, the 2003 Regulations should also disapply paragraphs 99(3) and 99(4) of Schedule B1 to the IA 1986 (administrator's remuneration and administrator's expenses to be paid in priority to the claims secured by a floating charge) and Section 176ZA of the IA 1986 (liquidator's remuneration and winding-up expenses to be paid in priority to the claims secured by a floating charge).

If a statutory provision is introduced implementing the proposal contained in the Moratorium Consultation Paper so that moratorium expenses rank ahead of claims secured by a floating charge, then it would obviously be necessary to disapply that statutory provision in so far as it might otherwise apply to any security financial collateral arrangement.

We should point out that "expenses" of an insolvency are not limited to the insolvency office-holder's fees, but include the entire day-to-day running costs of the procedure. In an administration, which is intended in the first place to be a rescue procedure for an ailing company, the administrator is under a statutory duty to attempt to save the company as a going concern; accordingly, the running costs will be very significant indeed, including staff, premises, supplies, utilities and services.

We regard the disapplication of these provisions as of great importance.

Institutions conducting business in the financial markets would naturally assume that any form of security on financial collateral protected under the terms of the Regulations would allow them, on enforcement, to keep the entirety of the net proceeds of realisation. There are dangers to London as a financial centre in not meeting the reasonable expectations of persons conducting business there.

The modelling of cash flows in securitisation and structured finance transaction where administration or liquidation is a potential outcome has presented particular problems for rating agencies.

Other European Union jurisdictions have implemented the FCD without imposing this sort of barrier on the taking of security on financial collateral. For example, the position in France is that, provided that the conditions to benefit from the favourable financial collateral regime are met, there are not any expenses that would rank ahead of the security.[36] Similarly, the position in Germany is that the administrator of an

[36] The regime applicable to financial collateral in France excludes any rule that would otherwise impose priority rankings for preferential creditors (e.g. employees wages, tax debts, judicial expenses). Article L.431-7-5 of the French Monetary and Financial Code provides that the provisions of Book VI of the Commercial Code (relating to insolvency) or the equivalent governing any amicable or judicial proceedings

insolvent company generally has a right to realise the moveable assets of the company, including receivables assigned by the company by way of security, and in doing so can deduct costs equal to 5% of the realisation proceeds. However, this does not apply to financial collateral protected under the FCD.

We note from paragraph 3.3 of the Consultation Paper that H.M. Treasury (and, we understand, the Insolvency Service) is concerned that an appropriate level of protection should be provided to unsecured creditors who might be unaware that a floating charge had been created.

If our suggestion for the disapplication of the provisions that give priority to administration and winding-up expenses over the claims secured by a floating charge gives rise to the concerns expressed in paragraph 3.3 of the Consultation Paper, one solution might be to limit the disapplication to situations in which the floating charge was granted as part of a "wholesale arrangement" (as to which, please see paragraph 1.18 et seq. of our response).

8. ***Vires***

The question of whether the 2003 Regulations were *ultra vires* the European Communities Act 1972 was raised by Professor Cranston in his evidence to the High Court of the British Virgin Islands in the case of *Alfa Telecom Turkey Limited v Cukurova Finance International Limited and another*. This was on the basis that under Article 1(2) of the FCD, both the collateral-taker and the collateral-provider must belong to one of the categories set out in that Article, whereas all that the 2003 Regulations require is that the collateral-taker and the collateral-provider should both be "non-natural persons"[37]. The point was not raised when the case went to appeal[38]. However, the validity of the Regulations was challenged in judicial review proceedings in England,[39] but the proceedings were dismissed as being out of time. Although it is therefore unlikely that the vires issue will be raised again, we would suggest that it would be prudent to re-enact the 2003 Regulations using the powers conferred by section 255 of the 2009 Act and to provide expressly in the Regulations that anything done under or in reliance on the 2003 Regulations as previously in force should be treated as having had effect despite any lack of *vires* (see sub-section 255(5)(c)). For reasons given elsewhere in this response, we consider that it would in any event be desirable to use the powers conferred by section 255 to give effect to a number of the other changes that we have suggested.

9. **Part VII Companies Act 1989**

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opened outside France shall not interfere with the rights of the financial collateral-taker. The French Trésor, which has been leading the implementation of the FCD in France, has been concerned to keep the existing safe harbour for financial collateral so that such collateral will not be challenged by any other creditor in the course of an insolvency proceeding.

37 See definitions of "security financial collateral arrangement" and "title transfer financial collateral arrangement" in Regulation 3.

38 Eastern Caribbean Court of Appeal: HCVAP 2007/027 29 January/ 22 April 2008; Privy Council: Times Law Reports 25 May 2009.

39 *R (Cukurova Finance International Limited and Cukurova Holdings A.S.) v H.M. Treasury and Alfa Telecom Turkey Limited* 15 and 16 July 2008 (unreported).

H.M. Treasury indicated in 2008 that there would be a further consultation on Part VII which would address the wider issues. We should be interested to hear when this consultation is to take place.

In our view, a further review is required. To give one example, while the Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 provides specific protection for market contracts and default and settlement rules of recognised clearing houses or recognised investment exchanges, this does not extend to systems and arrangements covered by the 2003 Regulations or the 1999 Regulations. It may well be that the latter are intended to be covered by the general safeguard in those Regulations for community law. However, this might not assist to the extent that the Regulations currently go, or are amended to go, beyond the scope of the relevant Directives.

APPENDIX C

EXTRACT FROM PAPER SUBMITTED TO H.M. TREASURY IN SEPTEMBER 2007 CONCERNING A POSSIBLE EXCEPTION TO THE "CONTROL" TEST WHERE THE CHARGE IS GRANTED AS PART OF A "WHOLESALE ARRANGEMENT"

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

6. SYSTEM CHARGES AND COLLATERAL SECURITY CHARGES

6.1 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.

6.2 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).[40]

6.3 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[41] and allow the control test to be satisfied if "negative control"[42] exists, then there will be good grounds for arguing that 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.

6.4 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[43] (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.

6.5 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).

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40 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**").

41 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.

42 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.

43 Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements (the "**Directive**").

7. MARKET CHARGES

7.2 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.

7.3 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.

7.4 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[44] and the power of the administrator to deal with charged property[45] as well as (in certain circumstances) the statutory avoidance of any disposition of property effected after the commencement of winding up.[46]

7.5 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.

8. WHOLESALE ARRANGEMENT

8.2 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,[47] 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,[48] the avoidance of property dispositions

44 Paragraph 43(2) of Schedule B1 to the Insolvency Act 1986 (the "**1986 Act**").
45 Paragraphs 70(1) and 71(1) of Schedule B1 to the 1986 Act.
46 Section 127 of the 1986 Act.
47 Regulation 4(4) of the FCA Regulations.
48 Regulation 8 of the FCA Regulations.

effected after the commencement of the winding up,[49] the allocation of a prescribed part of the company's net property for unsecured creditors,[50] the avoidance of floating charges created by an insolvent company[51] and the payment of preferential debts out of assets subject to a floating charge.[52] 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,[53] 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.

8.3 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.[54]

8.4 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.[55] 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.

8.5 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.

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49 Regulation 10(1)(a) of the FCA Regulations.
50 Regulation 10(3) of the FCA Regulations.
51 Regulation 10(5) of the FCA Regulations.
52 Regulation 10(6) of the FCA Regulations.
53 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.
54 The prohibition is contained in section 72A of the 1986 Act and the exception is contained in section 72B of the Act.
55 See, for example, *Feetum and others v Levy and others* [2005] EWCA Civ 1601, [2006] 2 BCLC 102.

8.6 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.

8.7 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.

8.8 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.

8.9 The specified sum would not necessarily be the same sum as applies to the capital market exception.[56] "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".

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

9. "GAP" ANALYSIS IN RELATION TO THE FCA REGULATIONS

9.2 We attach as Appendix II a paper that we sent to H.M. Treasury in August 2005 commenting on the draft Financial Collateral Arrangements (No. 2) Amendment Regulations 2005 which had been informally circulated by H.M. Treasury to interested parties. This coupled with the amendments that were included in the draft

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

itself (also included within Appendix II) should serve as a "gap" analysis in relation to the FCA Regulations in their current form.

10. IMPLEMENTATION

10.2 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.

10.3 It will be a matter for H.M. 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. H.M. 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 H.M. 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.[57] As a result of the recent consultation exercise[58], it may be possible to persuade the European 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.

10.4 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.[59] 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, H.M. Treasury should seek at the earliest opportunity to deal with the exclusion of system charges, collateral security charges and market

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

[58] 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 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.

[59] 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.

charges and also wholesale arrangements (ideally) by primary legislation without waiting for the wording to be finalised.

10.5 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,[60] a further disapplication is required. Again, this is likely to require either an amendment to the Directive (followed by regulations made by H.M. Treasury under section 2(2) of the 1972 Act) or primary legislation.[61]

10.6 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 H.M. 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.

11. THE WAY FORWARD

11.2 We would be very happy to attend a further meeting with H.M. 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.

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

[61] 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[62]. 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));

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

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

(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 H.M. 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 H.M. 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[63] (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

[63] 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.

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;

(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 H.M. 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)*[64]; 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'

[64] 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.

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;

(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 H.M. TREASURY IN AUGUST 2005

WORKING GROUP ON THE IMPLEMENTATION OF THE FINANCIAL COLLATERAL ARRANGEMENTS DIRECTIVE (2002/47/EC) (the "Directive")

THE FINANCIAL COLLATERAL ARRANGEMENTS (NO.2) (AMENDMENT) REGULATIONS 2005 (the "Amendment Regulations")

(A) MATTERS NOT DEALT WITH BY THE DRAFT AMENDMENT REGULATIONS

(B) THE PROVISIONS OF THE DRAFT AMENDMENT REGULATIONS

APPENDIX D

SUGGESTED DRAFTING CHANGES TO THE 1999 REGULATIONS

A. Changes required to ensure protection is extended to designated systems in the face of the insolvency of a participant in an interoperable system (see paragraphs 2.20 to 2.22 of this response)

(1) Definition of "central counterparty"

In the second line, insert "or in a system which is an interoperable system in relation to that designated system" after the words "in a designated system".

Similar changes are required to the definitions of "clearing house" and "settlement agent".

(2) Definition of "collateral security"

In paragraph (a), insert "or with a system which is an interoperable system in relation to that designated system" after the words, "in connection with a designated system".

(3) Definition of "default arrangements"

In the first line, insert "or by a system which is an interoperable system in relation to that designated system" after the words, "put in place by a designated system".

(4) Definition of "defaulter"

In the second line, insert "or by a system which is an interoperable system in relation to that designated system" after the words, "taken by a designated system".

(5) Definition of "institution"

In the first line after paragraph (e), insert "or in a system which is an interoperable system in relation to that designated system" after the words, "which participates in a designated system".

(6) Definition of "rules"

In the first line, insert "or a system which is an interoperable system in relation to that designated system" after the words, "in relation to a designated system".

(7) Definition of "settlement account"

In the last line, insert "or in a system which is an interoperable system in relation to that designated system" after the words, "in a designated system".

(8) Definition of "transfer order"

In the last line of paragraph (a), insert "or of a system which is an interoperable system in relation to that designated system" after the words, "the rules of a designated system".

(9) Regulation 13(1)

In the first line of paragraph (a), insert "or through a system which is an interoperable system in relation to that designated system" after the words, "through a designated system".

In the second line of paragraph (a), delete the words "a designated system" and insert the words, "of such a system".

(10) Regulation 13(2)

The suggested changes made to the definition of "institution" above mean that the term "participant" would properly extend to both a participant of a designated system and a participant of an interoperable system in relation to that designated system, without more. This would now make the proposed changes to regulation 13(2) syntactically correct.

(11) Regulation 14

In order to maintain consistency in the language used by the 1999 Regulations when referring to arrangements with interoperable systems, in paragraphs (b) and (d) of regulation 14(1) reference should be made to "of/in a designated system or of/in a system which is an interoperable system in relation to that designated system".

In addition, in paragraph (c) of regulation 14(1), in the first line insert "or of a system which is an interoperable system in relation to that designated system" after the words, "the rules of a designated system".

Corresponding changes are required to paragraphs (a) and (c) of Regulation 14(2).

(12) Regulations 16(3) and 17(3)

In the first line of paragraph (d), insert "or of a system which is an interoperable system in relation to that designated system" after the words, "the rules of a designated system".

(13) Regulation 20(1)

In the second line of the chapeau for regulation 20(1), insert "or into a system which is an interoperable system in relation to that designated system" after the words, "is entered into a designated system".

The suggested changes made to the definition of "institution" above mean that the term "participant" would properly extend to both a participant of a designated system and a participant of an interoperable system in relation to that designated system, without more. As a result in regulation 20(1):

(a) paragraph (a)(ii) ("a participant of an interoperable system of the designated system") should be deleted;

(b) in paragraphs (b) and (c), the words "a participant of an interoperable system of the designated system" should be deleted; and

(c) in paragraphs (b) and (c) the words "or of a system which is an interoperable system in relation to that designated system" after the words, "a system operator of that designated system".

(14) Regulation 20(2)

Regulation 20(2), in order to be consistent with Article 3(1) of the SFD as amended, should we suggest read as follows:

"The conditions referred to in paragraph (1) are that -

(d) the transfer order is carried out on the same business day, as defined by the rules of the designated system or of the system which is an interoperable system in relation to that designated system, that the event specified in paragraph (1)(a), (b) or (c) occurs, and

(e) the system operator of the designated system or, as the case may be, of the system which is an interoperable system in relation to that designated system can show that it did not have notice of that event at the time of settlement of the transfer order."

(15) Regulation 21(1)

In paragraph (a), insert "or through a system which is an interoperable system in relation to that designated system" after the words, "through a designated system".

(16) Schedule, paragraphs 5(1A) and 5(1B)

In view of paragraph 1(5) of the Schedule (which itself reflects a change made to Article 2(a) of the SFD by the Amending Directive), we think it would be misleading in paragraph 5(1A) of the Schedule to refer to "where the system has one or more interoperable systems" – as the arrangements between interoperable systems cannot themselves constitute a "system" for the purposes of the SFD.

We would suggest that paragraphs 5(1A) and (1B) might be better drafted along the following lines:

"5(1A) Where the system is a "first system" for the purpose of the definition of "interoperable system" –

(f) the rules required under paragraphs (1)(a) and (b) shall, as far as possible, be co-ordinated with the rules of the second system in order to avoid legal uncertainty and limit systemic risk; and

(g) the rules of the first system which are referred to in paragraphs (1)(a) and (b) shall not be affected by any rules of the second system in the absence of express provision in the rules of both the first system and the second system".

B. Changes required in relation to "indirect participants" (see paragraphs 2.17 to 2.19 of this response)

(17) Definition of "indirect participant"

In paragraph (b), insert "or is made known to that system operator in accordance with the system's default arrangements" after the words, "which is known to the system operator".

(18) Regulation 10(1)

In the third line of regulation 10(1), insert the words "the identity of which is known to the system operator" after the words, "(including the indirect participants…)".

C. Miscellaneous drafting changes

(19) Definition of "system operator"

In some designated systems, it would be more accurate to describe the operator of that system as the person who is responsible for "managing" the system. This distinction is reflected, for example, in the definition of "operator" in section 183(a) of the Banking Act 2009. For this reason, we would suggest that the words "or management" are inserted after the words "responsible for the operation" in the first line of the definition.

(20) Definition of "institution"

In paragraph (d) of this definition, there needs to be an additional reference to "(aa)" as well as to "(a) and (b) above". This is needed to pick up the insertion of electronic money institutions. A similar cross-referencing point would arise if H.M. Treasury agrees with our proposal that "payment institutions" under the PSRs should be included within the definition of "institution" (see paragraph 2.14 of this response).

(21) Definition of "Settlement Finality Directive"

In view of the importance of the changes effected to the SFD by the Amending Directive, we would suggest that this definition expressly refers to the directive *as amended by the Amending Directive.*

(22) Regulation 9(1)

In order to be consistent with the formulation in, for example, regulation 8(2) the words "and to the system operator of that system" should be inserted at the end of the paragraph under (b) of regulation 9(1).

(23) Regulation 9(2)

In order to be consistent with the language of Article 2(f) of the SFD (as amended) and the definition of "system operator", we would suggest that the word "liability" in the second line of regulation 9(2) be replaced by the words "legal responsibility".

APPENDIX E

THE FINANCIAL MARKETS AND INSOLVENCY (SETTLEMENT FINALITY REGULATIONS 1999 AMENDED TO INCLUDE CHANGES APPEARING IN THE SI ATTACHED TO THE CONSULTATION PAPER AND AS FURTHER AMENDED BY THE FINANCIAL LAW COMMITTEE

Important Note

The amendments to the Regulations that are suggested in this Appendix are not comprehensive or definitive and are only intended to illustrate the sort of changes that might be required to deal with certain of the problems identified in Appendix D.

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APPENDIX F

THE FINANCIAL COLLATERAL ARRANGEMENTS (NO.2) REGULATIONS 2003 AMENDED TO INCLUDE CHANGES APPEARING IN THE SI ATTACHED TO THE CONSULTATION PAPER AND AS FURTHER AMENDED BY THE FINANCIAL LAW COMMITTEE

Important Note

The amendments to the Regulations that are suggested in this Appendix are not comprehensive or definitive and are only intended to illustrate the sort of changes that might be required to deal with certain of the problems identified in Appendix B.

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