FINANCIAL COLLATERAL:

A PROPOSAL FOR ITS "PROVISION"

A. Introduction

1. The Financial Law Committee of the City of London Law Society (the **Committee** or **we**) has been working to develop a draft Secured Transactions Code (the **Code**). The purpose of the Code is to create a new English law of secured transactions, based on the existing law but simplifying and modernising it. We have received a great deal of support for the idea of doing this and the approach of the Code. We have considered a lot of comments from a wide variety of interested people, including many academics and practising lawyers.

2. In conjunction with the Code, the Committee has prepared a draft Secured Transactions Code and Commentary (the **Commentary**). The purpose of the Commentary is to put the new law set out in the Code into context, explain why the Code says what it does and give examples of how the law should be applied in practice.

3. Our intention is that the Code should be brought into law by enabling legislation. The legislation could give the Commentary official standing as a guide to the interpretation of the Code and any other rules or provisions of an enactment or common law that are used or referred to in the Code.

4. We believe that the latest draft of the Code has achieved a broad consensus of support[1]. However, one of the clear messages that we have received in progressing the draft Code is that there is wide-spread concern that the existing English law on financial collateral is not fit for purpose in the modern world. This is viewed as a matter of critical significance to the stability and competitiveness of the UK's financial system, especially after the UK's withdrawal from the European Union. As such, we have reflected upon whether the Code would be the most apposite place to deal with the issues that have been identified.

6. However, while there are certain matters relating to the law on financial collateral that in our view should be governed by the Code (for example, the rules governing priority), we have concluded that most (if not all) of the issues raised would be better dealt with through appropriate amendments to the FCARs[2].

7. Accordingly, the Committee is taking forward, in conjunction with its work on the Code, a separate work-steam. The aim of this work-stream is to seek support for certain changes to the FCARs that we consider necessary or desirable to enable relevant collateral

[1] The current version of the draft Code and Commentary (each dated March 2020) can be found on the CLLS website: *[insert link here]*

[2] The Financial Collateral Arrangements (No.2) Regulations 2003 (as amended). The FCARs implemented into UK law the provisions of Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (as amended, the **FCD**).

arrangements[3] governed by English law to be commercially useful, workable, safe and effective as part of the UK's modern, dynamic and internationally-focused financial markets[4].

8. This paper[5] has been prepared by the Committee with regard to one specific, but fundamental, concern arising out of the practical operation of the FCARs: the requirement that financial collateral must be "provided"[6] by the collateral-giver[7] to the collateral-taker before the benefits of the FCARs can be applied to the relevant collateral arrangement concerned.

B. The practical operation of our financial collateral laws: a fundamental concern

9. Financial collateral (comprising financial instruments, cash and credit claims) is used widely in the UK financial markets, and in connection with central bank monetary operations, as a key component for the management of credit, liquidity, systemic and other risks.

10. The adoption of the FCD was intended to introduce measures that would contribute to the efficient, safe and stable operation of the EU financial markets (see Recitals (3) and (12)); to improve the legal certainty of financial collateral arrangements (see Recital (5)); to limit the administrative burdens for parties using financial collateral (see Recital (9)); and to provide rapid and non-formalistic enforcement procedures to safeguard financial stability and limit contagion effects in case of a default of a party to a financial collateral arrangement (see Recital (17)).

11. In implementing the FCD, and with reference to the minimum harmonization nature of the FCD (see Recital (22)), HM Treasury took extensive steps to ensure that the FCARs included

---

[3] We use the term **relevant collateral arrangement** in this paper to refer to an agreement or arrangement under which financial collateral (in the form of cash, securities or credit claims) is used as security in respect of a loan or other liability.

[4] We note that HM Treasury has a power under section 255 of the Banking Act 2009 to make regulations about relevant collateral arrangements. Under that section, such regulations may make any provision that HM Treasury thinks necessary or desirable: (1) for the purpose of enabling relevant collateral arrangements, whether or not with an international element, to be commercially useful and effective (s. 255(3)(b)); and (2) to achieve or restore certainty and stability in connection with the matters to which the FCARs relate (s. 255(5)(d)).

[5] The Committee has prepared a separate paper on other amendments that it considers necessary or desirable to be made to the FCARs. While this split has been done to give particular focus and clarity to the widely expressed concerns on the seminal issue of the "provision" of financial collateral as discussed in this paper, we would wish to address and take forward with HM Treasury in tandem each of the proposals that we have set out in our two papers.

[6] The concept of "provision" derives from: (1) the definition of "security financial collateral arrangement" in Article 2(1)(c) of the FCD (which requires that, in order to qualify for the protections afforded to a security financial collateral arrangement under the FCD, the relevant collateral must be "provided" by the collateral-giver to the collateral-taker); and (2) Article 2(2), which states that for financial collateral to be so "provided", it 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 finds expression in the UK's implementation of the FCD through the definition of "security financial collateral arrangement": see FCARs, regulation 2(1) (paragraph (c) of the definition).

[7] We use the more neutral term **collateral-giver**, rather than "collateral-provider", to refer to the person who creates a security interest in financial collateral in favour of the collateral-taker. This is appropriate in our view because, for the reasons we explore later in this paper, financial collateral may not in fact be "provided" under a particular relevant collateral arrangement and, as a result, the arrangement may not satisfy one of the core conditions for qualification as a security financial collateral arrangement for the purposes of the FCARs.

a number of helpful provisions that sought to achieve the objectives of the FCD as applying to the particular structural considerations of the UK's financial markets.

12. The provisions of the FCARs have been kept periodically under review. In 2010, an amendment (the **2010 Amendment**)[8] was made to clarify that "possession" of financial collateral (in the form of financial instruments or cash) includes the case where:

> *"financial collateral has been credited to an account in the name of the collateral-taker or a person acting on his behalf (whether or not the collateral-taker, or a person acting on his behalf, has credited the financial collateral to an account in the name of the collateral-taker on his, or that person's books) provided that any rights the collateral-provider may have in relation to that financial collateral are limited to the right to substitute financial collateral of the same or greater value or withdraw excess financial collateral".*

13. However, notwithstanding the 2010 Amendment[9], it has become apparent that the manner in which many relevant collateral arrangements (governed by English law) operate in practice in the UK's financial markets does not, or may not[10], comply with the requirement for "provision" under the FCARs. Particular concerns have arisen with respect to the eligibility of relevant collateral arrangements commonly used in the UK markets, including:

---

[8] Pursuant to regulation 4 of the Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations 2010. The amendment was made in response to the views expressed by Vos J. in *Gray & Others -v- G-T-P Group Ltd., Re F2G Realisations Ltd. (in liquidation) [2010] EWHC 1772 (Ch.)* (the **Gray judgment**) that, for the purposes of the FCARs and English law more generally, "possession" has no meaning as regards intangible property.

[9] Indeed, it is fair to say that the non-exclusive definition of "possession" brought into effect by the 2010 Amendment has itself introduced additional legal uncertainty. This is because the proviso in the definition suggests that, if rights are reserved to the collateral-giver that extend beyond a right of substitution or withdrawal of "excess" collateral, the collateral-taker will not have possession of the relevant financial collateral. This appeared to reflect an interpretation of the final sentence of Article 2(2) of the FCD as a comprehensive description of the rights which may, after a qualifying provision, nonetheless reside with the collateral-giver, so that the enjoyment by the giver of any different or wider rights would be fatal to the requirement for "possession". This interpretative approach was subsequently doubted by Briggs J. in *Re Lehman Brothers International (Europe) (in administration) [2012] EWHC 2997 (Ch.)* (the **Extended Liens judgment**).

[10] Legal uncertainty as to whether a particular charge, and its related contractual arrangements, may or may not be eligible for protection under the FCARs is equally damaging to the smooth and cost-effective operation of the UK's financial markets. Due to the potentially severe consequences for a collateral-taker in making a wrong decision on this point, the tendency is for market participants to proceed on the basis that the FCARs do not apply. In consequence, the intended benefits of the Regulations fail to find practical expression in market practice. If market participants structure their transactions on the basis that the FCARs do apply, they will rarely obtain a "clean" legal opinion on issues relevant to the validity or enforceability of the transaction. The specific issue for English law security interests over financial collateral, with reference to the requirement for provision of financial collateral, has been highlighted by both the Gray judgment (which was handed down before the 2010 Amendment) and the Extended Liens judgment (which was handed down after the 2010 Amendment). These judgments have underscored the necessity for a relevant collateral-taker to have a contractual or other legal right that enables it, prior to an enforcement event, to prevent the collateral-giver from using or dealing with the charged financial collateral so as to remove it from the collateral pool (this is, so-called, "legal, negative control"). The analysis on this aspect of relevant collateral arrangements by the English courts has since been confirmed, with respect to the corresponding provisions of the FCD, by the European Court of Justice in *Private Equity Insurance Group SIA -v- Swedbank AS, Case C-156/15*. The problem, however, is that none of these judgments provide clarity as to what rights, in practice, may be reserved by, or granted to, the collateral-giver in relation to financial collateral that might be considered to fall short of the right to "use" or "deal" with the collateral in the relevant sense; and so as to allow the continuing "provision" of the collateral under the FCARs/FCD. This is the case even in relation to the rights to substitute collateral or to withdraw "excess" collateral (which are expressly recognised in the legislation as not preventing the provision of financial collateral), in light of the range of operational arrangements that are in practice put in place to support the exercise of these rights.

(1) floating charges (unless, perhaps, the only reason why a charge is (re-) characterised as a floating charge is by reason of any right of substitution or withdrawal of "excess" financial collateral reserved to the collateral-giver);

(2) charges created on terms that, prior to enforcement, reserve residual rights and powers for the collateral-giver with respect to:

(a) the exercise of, or the enjoyment of the fruits of the exercise of, voting, notice or other rights attached to the charged financial collateral; and/or

(b) the receipt of interest, dividend or other income payments payable on the charged financial collateral;

(3) charges under which the collateral-giver has the right to withdraw "excess" financial collateral as determined by reference to:

(a) a proportion of the liabilities owed to the collateral-taker which may be less or more than 100% of those liabilities;

(b) a specified amount (which may be less or more than the liabilities owed to the collateral-taker); or

(c) some other formula or mechanism that ensures that the collateral-taker is at all times provided with an agreed and accepted level of collateralisation that may be less or more than the value of the liabilities at that time owed to the collateral-taker;

(4) charges under which the collateral-giver has a role with respect to the valuation of secured liabilities and/or the securities to be withdrawn as "excess" collateral or to replace, or be replaced as, substituted collateral; and

(5) charges under which the collateral-giver is entitled to require its custodian to return the collateral in the event that the collateral-taker becomes insolvent, but usually only after it has certified that it has discharged all secured liabilities[11].

14. These issues of legal uncertainty have undermined market confidence in the eligibility of English law relevant collateral arrangements to benefit from the protections that were intended to be afforded to them under the FCD. This means that many of the positive ambitions of the legislative framework introduced by the FCARs (in implementing the FCD) have failed to materialise for participants in the UK's and other international financial markets.

[11] The nature of these concerns, and the cumulative impact of the resulting legal uncertainty on different parts of the UK financial markets, has been previously highlighted by the work of the Financial Markets Law Committee (the **FMLC**) in this area: see the FMLC's report, *Analysis of uncertainty regarding the meaning of 'possession or… control' and 'excess financial collateral' under the Financial Collateral Arrangements (No. 2) Regulations 2003 (December 2012)*; and its subsequent letter dated 13 April 2015 to Mr. Richard Knox (Deputy Director, Securities and Markets, HM Treasury) entitled, *Meaning of "possession", "control" and "excess financial collateral" under the Financial Collateral Arrangements (No. 2) Regulations 2003*.

15. The Committee considers that, with regard to the clear need to support the efficient, safe and effective operation of the global financial system in response to recent (and ongoing) socio-political, economic and other market shocks, it is of critical importance that HM Government should now take the opportunity to resolve the concerns that have been widely expressed as to the effectiveness of the current legislative framework supporting relevant collateral arrangements. We also consider that, in light of the UK's withdrawal from the European Union, this is an appropriate time to evaluate what measures can and should be taken to maintain the global-standing[12] of the UK's financial markets, and fully to achieve the sound policy objectives and outcomes at the foundation of the legislative initiatives taken to date as relating to financial collateral.

C. A suggested way forward

16. In Annex 1 to this paper, we set out certain suggested amendments to the FCARs[13] that we believe would meet many of the concerns that have been expressed to us as part of our development of the Code and, previously, have been the subject of work undertaken by the FMLC.

17. We also believe that, in view of the paramount need to provide legal certainty to market participants with respect to the eligibility of their charge and related contractual arrangements, it is essential to provide authoritative practical and transparent guidance on how their relevant collateral arrangements can legitimately be structured and operated to benefit from the protections afforded to security financial collateral arrangements under the FCARs.

18. In the context of the Committee's work on the Code and Commentary, and as explained in paragraph 3 of this paper, we envisage that any legislation which might be put in place to give effect to the Code would also provide official standing to the Commentary. This might, for example, take the form of requiring an English court, when determining any relevant issue under the FCARs, to take account of any guidance on that issue set out in the Commentary. We would, of course, equally support any proposal under which such practical guidance could be given official standing before an English court: we do not believe that

[12] One way to maintain the global reputation of our markets is to ensure that the legal framework that supports their safe and efficient operation meets international best standards. Relevant collateral arrangements are used widely by systemically important financial market infrastructure to manage systemic and other risks arising out of their activities and the activities of their participants. The *CPMI-IOSCO Principles for financial market infrastructures (April 2012)* (the **PFMIs**) are internationally recognised standards of best practice designed to enhance safety and efficiency in payment, clearing and settlement arrangements and, more broadly, to limit systemic risk and foster transparency and financial stability. Under Principle 1 (*Legal basis*) of the PFMIs, an FMI is expected to have a well-founded, clear, transparent and enforceable legal basis for each material aspect of its activities in all relevant jurisdictions. This "legal basis" includes general laws and regulations that govern security interests (see paragraph 3.1.2 of the PFMIs) and, in accordance with Key Consideration 1, *"should provide a high degree of certainty"* for each material aspect of an FMI's activities in all relevant jurisdictions. The use of financial collateral by central counterparties, central securities depositories and payment systems to manage material risk would properly be considered, for this purpose, a "material aspect" of the FMI's activities. Implementation of the steps we propose in this paper, to enhance legal certainty as to the eligibility of English law relevant collateral arrangements to benefit from the protections afforded to security financial collateral arrangements under the FCARs, would provide substantial assistance to UK FMIs seeking to meet the PFMI 1 standard (in relation to their relevant collateral arrangements).

[13] It would, of course, be a matter for determination by HM Treasury as to whether it might be appropriate to make the proposed changes by way of a simple amendment instrument or by way of a consolidating instrument so as to have a single set of amended and re-stated Regulations dealing with relevant collateral arrangements under English law.

such guidance would have to be set out in the Commentary which we are developing to support the Code. This flexibility of options is accommodated by our proposals for amendments to the FCARs set out in Annex 1[14].

19. In Annex 2 to this paper, and by way of illustration as to how we envisage our legislative proposals might operate in practice, we have set out some potential practical guidance that we believe market participants would find helpful in interpreting the relevant provisions of the FCARs (as we propose they should be amended) on the "provision" requirement before a relevant collateral arrangement can qualify as a security financial collateral arrangement.

20. Members of the Committee would be delighted to meet representatives from HM Treasury to discuss the issues, and proposed solutions, set out in this paper.

Financial Law Committee
City of London Law Society
[ ] [ ] 202[ ]

[14] Specifically, we have suggested a power for HM Treasury: (1) itself, to issue "approved guidance" on matters relevant to a determination as to whether financial collateral is "provided"; or (2) to designate a body with sufficient resources, knowledge and expertise as an "appropriate body" and to approve any guidance issued by such a body relating to the "provision" of financial collateral: see regulation 20(1) to (6) of the FCARs as we propose they should be amended. We have also suggested that a court, in deciding whether a collateral-giver has "provided" financial collateral to a collateral-taker (or a person acting on its behalf), must consider any such approved guidance where it is relevant to the specific issue before the court: see regulation 20(7) of the FCARs as we propose they should be amended.

ANNEX 1:

SUGGESTED AMENDMENTS TO THE FCARs

1. In regulation 3(1) –

(1) before the definition of "book entry securities collateral", insert the following definitions –

""2000 Act" means the Financial Services and Markets Act 2000;

"account" means either or both of a cash account and a financial instruments account";

"account agreement" means –

(a) in relation to a cash account, the agreement between the account holder and the relevant account servicing institution governing the cash account;

(b) in relation to a financial instruments account, the agreement between the account holder and the relevant intermediary or relevant CSD governing the financial instruments account;

"account servicing institution" means a person that maintains cash accounts, for others or both for others and for its own account;

"appropriate body" means a body which is designated by the Treasury in accordance with regulation 20(4);

"appropriate notice" means, in relation to –

(a) notice of a control agreement received by an intermediary or an account servicing institution but to which it is not a party, notice that is receivable by the intermediary or the account servicing institution in accordance with the terms of its account agreement with the relevant collateral-giver;

(b) notice of a control agreement received by a CSD but to which the CSD is not a party, notice that is receivable by the CSD in accordance with the terms of its account agreement with the relevant collateral-giver or its rules;

"approved guidance" means guidance –

(a) issued by the Treasury or an appropriate body under regulation 20(2) with regard to the financial collateral principles; and

(b) (where the guidance is issued by an appropriate body) it is approved by the Treasury in accordance with regulation 20(5);";

(2) after the definition of "cash", insert the following definitions –

""cash account" means an account maintained by an account servicing institution to which cash may be credited or debited;

"cash control agreement" means an agreement (in relation to cash credited to a cash account in the name of a collateral-giver or a person acting on its behalf) –

(a) between the collateral-giver, the relevant account servicing institution and a collateral-taker (or a person acting on its behalf); or

(b) between the collateral-giver and a collateral-taker (or a person acting on its behalf) of which the relevant account servicing institution receives appropriate notice,

which in any such case includes either or both of the following provisions –

(i) that the relevant account servicing institution is not permitted to comply with any instructions given by the collateral-giver (or the person acting on its behalf) in relation to the cash to which the agreement relates without the consent of the collateral-taker (or the person acting on its behalf);

(ii) that the relevant account servicing institution is obliged to comply with any instructions given by the collateral-taker (or the person acting on its behalf) in relation to the cash to which the agreement relates in such circumstances and as to such matters as may be provided by the agreement, without any further consent of the collateral-giver (or the person acting on its behalf);

"cash designating entry" means an entry in, or other procedure in relation to, a cash account maintained in the name of a collateral-giver (or a person acting on its behalf) that is made, or operates, in favour of a collateral-taker or a person acting on its behalf which, under the account agreement or a cash control agreement has either or both of the following effects –

(a) that the relevant account servicing institution is not permitted to comply with any instructions given by the collateral-giver (or the person acting on its behalf) in relation to the cash as to which the entry is made without the consent of the collateral-taker (or the person acting on its behalf);

(b) that the relevant account servicing institution is obliged to comply with any instructions given by the collateral-taker (or the person acting on its behalf) in relation to the cash as to which the entry is made in such circumstances and as to such matters as may be provided by the account agreement or the control agreement, without any further consent of the collateral-giver (or the person acting on its behalf);"

(3) after the definition of "close-out netting", insert the following definition –

""control agreement" means either or both of a cash control agreement and a financial instruments control agreement;";

(4) after the definition of "credit claims", insert the following definitions –

""CSD" means a "central securities depository" within the meaning of section 417 of the 2000 Act;

"delivery" means transfer of possession, actual or constructive, from one person to another;

"designating entry" means either or both of a cash designating entry and a financial instruments designating entry;";

(5) after the definition of "financial collateral", insert the following definition –

""financial collateral principles" means the principles set out in regulation 20(6);";

(6) after the definition of "financial instruments", insert the following definitions –

"financial instruments account" means a register or account maintained by an intermediary or a CSD to which financial instruments may be credited or debited;

"financial instruments control agreement" means an agreement (in relation to financial instruments credited to a financial instruments account in the name of a collateral-giver or a person acting on its behalf) –

(a) between the collateral-giver, the relevant intermediary or the relevant CSD and a collateral-taker (or a person acting on its behalf); or

(b) between the collateral-giver and a collateral-taker (or a person acting on its behalf) of which the relevant intermediary or the relevant CSD receives appropriate notice,

which in any such case includes either or both of the following provisions –

(i) that the relevant intermediary or the relevant CSD is not permitted to comply with any instructions given by the collateral-giver (or the person acting on its behalf) in relation to the financial instruments to which the agreement relates without the consent of the collateral-taker (or the person acting on its behalf);

(ii) that the relevant intermediary or the relevant CSD is obliged to comply with any instructions given by the collateral-taker (or the person acting on its behalf) in relation to the financial instruments to which the agreement relates in such circumstances and as to such matters as may be provided by the agreement, without any further consent of the collateral-giver (or the person acting on its behalf);

"financial instruments designating entry" means an entry in, or other procedure in relation to, a financial instruments account maintained in the name of a collateral-giver (or a person acting on its behalf) that is made, or operates, in favour of a

collateral-taker or a person acting on its behalf which, under the account agreement, a financial instruments control agreement or the rules of a CSD has either or both of the following effects –

(a) that the relevant intermediary or the relevant CSD is not permitted to comply with any instructions given by the collateral-giver (or the person acting on its behalf) in relation to the financial instruments as to which the entry is made without the consent of the collateral-taker (or the person acting on its behalf);

(b) that the relevant intermediary or the relevant CSD is obliged to comply with any instructions given by the collateral-taker (or the person acting on its behalf) in relation to the financial instruments as to which the entry is made in such circumstances and as to such matters as may be provided by the account agreement, the control agreement or the rules of the relevant CSD, without any further consent of the collateral-giver (or the person acting on its behalf);";

(7) after the definition of "intermediary", insert the following definition –

""negotiable instrument" means a financial instrument title to which is transferred by delivery of the instrument from one person to another (whether with or without indorsement of the instrument);";

(8) after the definition of "recovery and resolution directive", insert the following definitions –

""registered instruments" means financial instruments title to which is constituted or evidenced by entry of the holder of the financial instruments on the relevant register of financial instruments;

"register of financial instruments" means a register or other record of financial instruments which is not maintained by a CSD and constitutes the primary record of entitlement to the relevant financial instruments as against the issuer of the instruments;";

(9) in the definition of "relevant account", delete all the words from "by which that book entry securities collateral is transferred or designated so as to be" to (and including) "under the control of" and substitute for them the words, "through which that book entry securities collateral is provided to";

(10) after the definition of "relevant account", insert the following definitions –

""relevant administrative control" means the control of financial collateral by a collateral-taker (or a person acting on its behalf) effected by any of the steps taken in relation to the financial collateral described in regulation 3(2);

"relevant administrative control arrangement" means an agreement or arrangement, evidenced in writing, where –

(a) the purpose of the agreement or arrangement is to secure the relevant financial obligations owed to the collateral-taker;

(b) the collateral-giver creates or there arises a security interest in financial collateral to secure those obligations;

(c) the financial collateral is in the relevant administrative control of the collateral-taker (or a person acting on its behalf); and

(d) the collateral-giver and the collateral-taker are both non-natural persons;";

(11) after the definition of "relevant financial obligations", insert the following definitions –

""relevant rights" means any or all of the following rights exercisable in relation to financial collateral which is securing or covering relevant financial obligations under a Relevant Rights Arrangement –

(a) in the case of financial collateral in the form of financial instruments, any right of the collateral-giver (prior to the occurrence of an enforcement event) to exercise (or to instruct the exercise of) for its own account or receive for its own account (or to instruct the collateral-taker or any other person to account to it for) any rights, privileges or benefits attached to or arising from such financial instruments, including, for example -

(i) to receive for its own account any interest, income, dividends or other distributions payable or deliverable in respect of such financial instruments;

(ii) to receive for its own account notices affecting or otherwise relating to such financial instruments, their issuer or any holder;

(iii) to exercise (or to instruct the exercise of) for its own account any voting rights exercisable in relation to such financial instruments; or

(iv) to give any instruction or make any election for its own account (or to require the collateral-taker or any other person to give an instruction or make an election) with respect to any rights exercisable in respect of such financial instruments relating to conversion, sub-division, consolidation, pre-emption, rights under a takeover offer or rights to receive financial instruments or a certificate which may at a future date be exchanged for financial instruments or other rights;

(b) in the case of financial collateral in the form of cash, any right of the collateral-giver (prior to the occurrence of an enforcement event) to receive for its own account (or to instruct the collateral-taker or any other person to account to it for) any interest or other income payable in respect of the financial collateral;

(c) in the case of financial collateral in the form of cash or financial instruments, any right of the collateral-giver to –

(i) substitute financial collateral of the same, equivalent or greater value or amount; or

(ii) withdraw excess financial collateral (or to instruct any such substitution or withdrawal); and

(d) any other right reserved by, or granted to, the collateral-giver –

(i) the exercise of which affects, or may come to affect, any of the collateral-taker's rights, privileges and benefits (or its enjoyment of any of the rights, privileges and benefits) that would otherwise arise from or in connection with its relevant administrative control of the financial collateral (or from such possession or control by a person acting on its behalf);

(ii) the exercise of which as a relevant right, in accordance with the terms of the Relevant Rights Arrangement, is consistent with the financial collateral principles;

"Relevant Rights Arrangement" means a relevant administrative control arrangement under which the financial collateral is in the relevant administrative control of the collateral-taker (or a person acting on its behalf) of a type described in regulation 3(2)(a), (b), (c)(i), (c)(ii) or (c)(iii);";

(12) after the definition of "reorganisation measures", insert the following definition –

""rules" means, in relation to a CSD, rules, practices, conditions, requirements, operating procedures, specifications, directions or other provisions that govern participation in the securities settlement system operated, or the provision of central maintenance services, by the CSD; and "rules" include any such provisions contained in, or required by, the law governing the services provided by the CSD;";

(13) substitute for paragraph (c) in the definition of "security financial collateral arrangement", the following –

"(c) the financial collateral is provided to the collateral-taker or a person acting on its behalf; and"; and

(14) in paragraph (d) in the definition of "security interest", delete all the words from (and including) "where the financial collateral charged" to the end of that paragraph.

2. Omit regulation 3(2) and substitute it with the following –

"(2) For the purposes of these Regulations, financial collateral may only be provided to the collateral-taker or a person acting on its behalf –

(a) (in the case of financial collateral in the form of financial instruments which are negotiable instruments) by the delivery of the financial collateral from the collateral-giver (or a person acting on its behalf) to the collateral-taker or a person acting on its behalf;

(b) (in the case of financial collateral in the form of financial instruments which are registered instruments) by –

(i) the entry of the name of the collateral-taker or a person acting on its behalf as holder of the financial collateral in the relevant register of financial instruments; or

(ii) delivery to the collateral-taker or a person acting on its behalf of the share certificate or other certificate evidencing title to the registered financial instruments (whether with or without a proper instrument of transfer executed by or on behalf of the collateral-giver in favour of the collateral-taker or a person acting on its behalf);

(c) (in the case of financial collateral in the form of cash credited to an account or financial instruments other than negotiable instruments or registered instruments) by –

(i) the financial collateral being credited to an account in the name of the collateral-taker or a person acting on its behalf (whether or not the collateral-taker, or the person acting on his behalf, has credited the financial collateral to an account in the name of the collateral-taker on his, or that person's books);

(ii) in relation to financial collateral credited to an account in the name of the collateral-giver (or a person acting on its behalf), a control agreement being entered into or, if the intermediary, the CSD or the account servicing institution is not a party to the control agreement, the intermediary, the CSD or the account servicing institution receiving appropriate notice of the control agreement, under which in either case –

(aa) the intermediary, the CSD or the account servicing institution is not permitted to comply with any instructions given by the account holder or (if different) the collateral-giver in relation to the financial

collateral without the consent of the collateral-taker or a person acting on its behalf;

(bb) the intermediary, the CSD or the account servicing institution is obliged to comply with any instructions given by the collateral-taker or a person acting on its behalf in relation to the financial collateral in such circumstances and in relation to such matters as may be provided by the agreement, without any further consent of the account holder or (if different) the collateral-giver;

(iii) in relation to financial collateral credited to an account in the name of the collateral-giver (or a person acting on its behalf), a designating entry being made in that account in favour of the collateral-taker or a person acting on its behalf;

(iv) in relation to financial collateral credited to an account in the name of the collateral-giver (or a person acting on its behalf), the collateral-giver creating a security interest in the financial collateral in favour of the intermediary, CSD or account servicing institution that maintains that account, as collateral-taker.

(3) The reservation by, or grant to, a collateral-giver of relevant rights in relation to financial collateral under a Relevant Rights Arrangement shall not prevent the provision of that collateral to the collateral-taker (or the person acting on its behalf).

(4) Where an intermediary, CSD or account servicing institution has relevant administrative control of financial collateral of the type described in regulation 3(2)(c)(iv), its relevant administrative control of the collateral shall effect the provision of the collateral to it, irrespective of whether or not:

(a) rights are reserved by, or granted to, the collateral-giver in relation to the collateral; or

(b) the rights reserved by, or granted to, the collateral-giver in relation to the collateral are or are nor relevant rights.

(5) The same person may act, with respect to a collateral-giver (or a person acting on its behalf), in the capacity of –

(a) an account servicing institution for cash credited to a cash account in the name of the collateral-giver (or a person acting on its behalf) maintained by that person; and

(b) an intermediary or a CSD for financial instruments credited to a financial instruments account in the name of the collateral-giver (or a person acting on its behalf) maintained by that person."

3. After regulation 19, insert a new Part 6 as follows –

"**PART 6**

Approved guidance

Power to issue approved guidance

20. – (1) The Treasury may –

(a) issue guidance under paragraph (2); or

(b) approve under paragraph (5) guidance issued by an appropriate body.

(2) The Treasury or an appropriate body may issue guidance –

(a) on any matter that it considers appropriate or necessary to assist the interpretation and practical application of –

(i) any of paragraphs (a) to (c) of the definition of "relevant rights" in regulation 3(1); and

(ii) regulations 3(2) and 3(3);

(b) that describes those other rights that may be reserved by, or granted to, a collateral-giver in relation to financial collateral and whose categorisation as "relevant rights", for the purposes of these Regulations, is considered by the Treasury or, as the case may be, the appropriate body to be consistent with the financial collateral principles.

(3) When issuing guidance, the Treasury or an appropriate body must have regard to the financial collateral principles.

(4) The Treasury may designate a body as an appropriate body if the Treasury determines that the body has sufficient resources, knowledge and expertise to perform the functions of a body issuing approved guidance.

(5) The Treasury may approve guidance issued by an appropriate body under regulation 20(2) if it is satisfied that the guidance –

(a) has been issued by the appropriate body with regard to the financial collateral principles; and

(b) will at all relevant times be published in a manner that the Treasury has approved as appropriate to bring it to the attention of persons likely to be affected by it.

(6) For the purposes of these Regulations, the "financial collateral principles" are that -

(a) a relevant administrative control arrangement should be commercially useful and effective with a view to its practical operation in managing or reducing risk for the parties to the arrangement and third parties;

(b) the administrative burdens for a collateral-taker under a relevant administrative control arrangement should be limited;

(c) rapid and non-formalistic enforcement procedures should be available to a collateral-taker under a relevant administrative control arrangement with a view to safeguarding financial stability and limiting contagion effects upon the occurrence of an enforcement event;

(d) the practical operation of a relevant administrative control arrangement should ensure a balance between market efficiency and the safety of the parties to the arrangement and third parties by minimising risk (including the risk of fraud); and

(e) the practical operation of a relevant administrative control arrangement should take into account the interest of the collateral-giver to dispose of, use or withdraw financial collateral in the relevant administrative control of the collateral-taker, where the collateral-taker agrees that the collateral is not required to secure or cover the relevant financial obligations owed to it.

(7) In deciding whether a collateral-giver has provided financial collateral to a collateral-taker or a person acting on its behalf for the purpose of these Regulations, the court must consider any approved guidance which is relevant to that issue.

ANNEX 2:

DRAFT GUIDANCE ON APPLICATION OF THE "PROVISION" TEST[1]

A. Introduction

1. This Guidance is issued by us[2] as an appropriate body designated by HM Treasury under regulation 20(4) of the Financial Collateral Arrangements (No. 2) Regulations 2003 (as amended, the **FCARs**)[3]. [It has been approved by HM Treasury in accordance with regulation 20(5) of the FCARs.]

2. The FCARs give certain important protections[4] to a security financial collateral arrangement (an **SFCA**). A security interest[5] over financial collateral[6] is commonly taken in relevant

[1] In preparing this draft Guidance, the Committee has adopted and built upon the analysis and reasoning of the FMLC as expressed in its report, *Analysis of uncertainty regarding the meaning of 'possession or… control' and 'excess financial collateral' under the Financial Collateral Arrangements (No. 2) Regulations 2003 (December 2012)*; and its subsequent letter dated 13 April 2015 to Mr. Richard Knox (Deputy Director, Securities and Markets, HM Treasury) entitled, *Meaning of "possession", "control" and "excess financial collateral" under the Financial Collateral Arrangements (No. 2) Regulations 2003*.

[2] The Committee has prepared this draft Guidance to illustrate how it envisages an appropriate body might use its power under suggested regulation 20(2) of the FCARs to issue approved guidance which would be of practical assistance to participants in the financial markets. Accordingly, we have prepared it from the perspective of (and as if it had been issued by) such an appropriate body, but without intending to suggest that the Committee itself could or would subsequently (or could or would wish to) be designated as such a body pursuant to HM Treasury's power in proposed regulation 20(4) of the FCARs. We have prepared this Guidance on the basis that HM Treasury might exercise its powers under section 255 of the Banking Act 2009 to make appropriate amendments to the Financial Collateral Arrangements (No. 2) Regulations 2003. However, it may be the case that, if HM Treasury is minded to make the changes that the Committee proposes in its papers, a better solution might be to amend and re-state the 2003 Regulations into a new set of stand-alone Regulations. That obviously remains a decision for HM Treasury alone, but it should not affect the substance of the analysis and conclusions set out in this draft Guidance.

[3] This Guidance represents our considered views, analysis and conclusions as to the matters covered by it and has been prepared by us, as an "appropriate body", with regard to the "financial collateral principles" set out in regulation 20(6) of the FCARs. However, it does not represent legal advice and we do not accept or assume any duty of care or other legal responsibility to any person in relation to our preparation, issue and publication of this Guidance.

[4] These protections include: (1) the disapplication of certain provisions of legislation that would (or might) otherwise require the formal validity of, the effectiveness of any assignment or other disposition of property under or the perfection of, an SFCA to be dependent upon the taking of a further formal or administrative act (e.g. as to writing or registration); (2) the disapplication of certain rules of insolvency law that would (or might) otherwise prevent or inhibit the rapid enforcement of a security interest under an SFCA (e.g. the administration moratorium); (3) the disapplication of certain anti-avoidance rules under insolvency law that would (or might) otherwise invalidate or avoid the security interest created, or the taking of realisation or other action, under or pursuant to an SFCA; (4) the giving of priority to the security interest created by an SFCA over preferential claims, administration or other expenses that would (or might) otherwise take precedence over the relevant financial obligations secured or otherwise covered by the SFCA; and (5) the recognition of rights of use and appropriation in relation to the financial collateral the subject of an SFCA that would (or might) not otherwise be available to a collateral-taker as a matter of general law under a relevant collateral arrangement that does not qualify as an SFCA. In addition, certain protections for SFCAs may be embedded in other legislative provisions. For example, SFCAs will benefit from the exclusions to the new provisions likely to be incorporated into the Insolvency Act 1986, by way of amendments effected through the prospective Corporate Insolvency and Governance Act 2020, in relation to: (a) moratoriums obtained by "eligible companies" under Part A1 of the 1986 Act; (b) the right for a company subject to the new moratorium to dispose of assets subject to a security interest; and (c) the limitations on the exercise of termination rights in supply contracts triggered by "relevant insolvency procedures" (in new section 233BA of the 1986 Act).

[5] A security interest for this purpose comprises the four types of consensual security interest recognised by English law, namely the pledge, mortgage, charge (fixed and floating) and lien: see the definition of "security interest" in regulation 3(1), FCARs.

[6] Financial collateral comprises those key types of liquid assets that are widely used in the financial markets to secure the exposure that one participant (or group of participants) has to another participant, namely cash, financial instruments and credit claims: see the definition of "financial collateral" in regulation 3(1), FCARs.

collateral arrangements[7] between institutions, companies and other entities[8] in the financial markets to secure relevant financial obligations[9].

3. The benefit of financial collateral is that, as a general matter, it is highly liquid and readily realisable upon the occurrence of a default or other enforcement event affecting the debtor. The rapid and unhindered enforcement of a security interest over financial collateral is an important method to minimise the credit, liquidity and other risks that the collateral-taker assumes in its relationship with the debtor. It plays a material role in limiting the risk that a default by one debtor might be transmitted and amplified through the channel of the creditor's exposure to create a financial shock to other parts of the domestic or international financial markets. Legal certainty that financial collateral can deliver these benefits plays a key role in ensuring public confidence in the financial system.

4. Safe, efficient and effective markets contribute to maintaining financial stability and economic growth. It is because relevant collateral arrangements are considered to help deliver these significant benefits that legislators and policy-makers have determined that, subject to certain important safeguards, such arrangements should be afforded protections that are not accorded to other types of security arrangement.

5. The FCARs prescribe a number of conditions that must be satisfied before a relevant collateral arrangement may qualify as an SFCA under the Regulations. These conditions impose proportionate requirements for SFCAs. They are not intended unduly to restrict the use of such security financial collateral arrangements, as any such restriction would result in a failure of the Regulations to achieve the beneficial policy objectives outlined above. However, these objectives must be balanced against two key countervailing policy considerations, namely:

   (1) the need to ensure that, while supporting the safe and efficient operation of the financial markets, the FCARs do not inadvertently create material operational risks (including the risk of fraud) for creditors of either party to the arrangement or other third parties[10]; and

---

[7] We use the term **relevant collateral arrangement** to refer to an agreement or arrangement under which financial collateral (in the form of cash, securities or credit claims) is used as security in respect of a loan or other liability.

[8] Such institutions might include: (1) central banks; (2) financial market infrastructures (such as central counterparties, central securities depositories and payment systems); (3) banks; (4) investment firms; (5) public authorities or other public sector bodies; (6) insurance companies; and (7) investment funds. However, in recognition of certain unique, structural aspects of the UK's financial markets, the protections of the FCARs are not limited to SFCAs to which such institutions are party. An arrangement under which both parties are "non-natural persons" may also qualify as an SFCA (subject to satisfaction of the other conditions set out in the definition of "security financial collateral arrangement" in regulation 3(1), FCARs). For this purpose, a "non-natural person" is any corporate body, unincorporated firm, partnership or body with legal personality except an individual. It includes any such entity constituted under the law of a country or territory outside of the UK or any such entity constituted under international law.

[9] See the definition of "relevant financial obligations" in regulation 3(1), FCARs.

[10] As relevant particulars of an SFCA are not required to be entered on a public register in order to perfect the relevant security interest, there is a risk (absent suitable safeguards) that: (1) creditors of the collateral-giver may deal with that party on the (mistaken) basis that it has free, unencumbered access to assets that the party has in fact provided as charged financial collateral to a collateral-taker; and (2) creditors of the collateral-taker may deal with that party on a (mistaken) understanding as to the nature and extent of the interest that the collateral-taker has in financial collateral to which it may have possessory or other legal title. In this latter case, a concern might be

(2) the need to take into account the interests of other creditors of the collateral-giver[11].

6. The balancing of these relevant considerations is reflected in:

(1) the requirement that, in order to qualify as an SFCA for the purposes of the FCARs, the financial collateral must be "provided"[12] by the collateral-giver to the collateral-taker (or a person acting on the collateral-taker's behalf);

(2) the protections afforded to security interests created in favour of intermediaries, CSDs and account servicing institutions to encourage or otherwise facilitate their making available credit or liquidity arrangements to account holders to support their financial markets operations[13];

(3) the express recognition in the FCARs that for SFCAs that are not of the type described in paragraph (2) above, certain rights may be reserved by, or granted to, the collateral-giver in relation to financial collateral under the terms of the SFCA which will not prevent that collateral being "provided" to the collateral-taker (or a person acting on its behalf)[14]; and

---

that creditors of the collateral-taker would assume (absent registration of the financial collateral charge) that the collateral-taker has absolute beneficial title to the assets; or, if aware that the financial collateral is acting as security for a liability owed to the collateral-taker, the interest of the collateral-taker in the secured assets cannot be freely and unilaterally terminated by action of the collateral-giver prior to the discharge of the relevant financial obligations.

[11] The preferential treatment accorded to a collateral-taker under an SFCA means that the financial collateral is likely to be diverted exclusively to the use of the collateral-taker to discharge in full the relevant financial obligations that are secured under the SFCA. The collateral-taker's interest can be freely realised without constraint by any relevant insolvency moratorium; the proceeds of realisation can be applied wholly to satisfy the relevant financial obligations without first having to meet the claims of preferential creditors or the expenses of any liquidator or administrator; the security interest, or any relevant disposition made under the SFCA, will be immune from challenge under certain anti-avoidance provisions of insolvency legislation; subject to the terms of the SFCA, the collateral-taker may have a right to use the financial collateral as if it were the owner of it (subject to an obligation to replace the original collateral with equivalent financial collateral); and the collateral-taker may appropriate the financial collateral by way of enforcement of its security interest (subject to certain valuation and accounting requirements in a commercially reasonable manner). The result of these benefits for an SFCA under the FCARs (and in other legislation) is that, when compared to a security arrangement that does not qualify as an SFCA, the insolvency estate of the collateral-giver may be materially depleted before it can meet the claims of other creditors.

[12] See paragraph (c) of the definition of "security financial collateral arrangement" in regulation 3(1), FCARs.

[13] The principal protection for such arrangements is that, in accordance with clause 3(4) of the FCARs, an intermediary, CSD or account servicing institution that has a security interest in financial collateral credited to an account maintained with it (and so has "relevant administrative control" of the type described in regulation 3(2)(c)(iv) of the FCARs) is considered without more to have had the collateral provided to it for the purposes of the FCARs. If created under a relevant administrative control arrangement, the security interest of the intermediary, CSD or account servicing institution will, therefore, automatically benefit from the protections afforded to SFCAs under the FCARs, irrespective of the nature or extent of the rights reserved by, or granted to, the account holder (as collateral-giver) with respect to its use, withdrawal or disposal of the financial collateral credited to its account from time to time.

[14] These rights are specified in paragraphs (a) to (c) of the definition of "relevant rights" in regulation 3(1), FCARs. They include the following rights for a collateral-giver: (1) the right (prior to an enforcement event) to receive for its own account interest, income, dividends or others distributions payable or deliverable in respect of financial instruments (see paragraph (a)(i)); (2) the right (prior to an enforcement event) to receive for its own account relevant notices in relation to rights under financial instruments (see paragraph (a)(ii)); (3) the right (prior to an enforcement event) to vote for its own account on financial instruments and appoint proxies (see paragraph (a)(iii)); (4) the right (prior to an enforcement event) for its own account to give instructions, and make elections, with respect to corporate actions affecting financial instruments (see paragraph (a)(iv)); (5) the right (prior to an enforcement event) to receive for its own account any interest payable in respect of a credit balance on a cash account (as a right within paragraph (b)); (6) the right to substitute financial collateral of the same, equivalent or greater value or amount (as a right within paragraph (c)(i)); and (7) the right to withdraw "excess" financial collateral (as a right within paragraph (c)(ii)).

(4) the power given to the Treasury or an "appropriate body"[15] to issue "approved guidance"[16] as to certain matters relevant to the interpretation and practical application of those regulations in the FCARs concerned with or otherwise relating to the "provision" of financial collateral[17].

B. Purpose and status of this Guidance

Purpose

7. This Guidance has the following objectives:

(1) to set out some general guidance on the approach to the interpretation of the concept of "provision" in the FCARs and the impact of certain powers of disposal reserved by, or granted to, the collateral-giver in relation to financial collateral (see Section C of this Guidance);

(2) to set out some specific guidance on the interpretation and practical application of the right of substitution specified in paragraph (c)(i) of the definition of "relevant rights" (see Section D of this Guidance);

(3) to set out some specific guidance on the interpretation and practical application of the right to withdraw "excess" financial collateral specified in paragraph (c)(ii) of the definition of "relevant rights" (see Section E of this Guidance); and

(4) to describe certain other rights that may be reserved by, or granted to, a collateral-giver in relation to financial collateral and which we consider should properly qualify as "relevant rights" for the purposes of the FCARs with regard to the financial collateral principles (see Section F of this Guidance).

8. This Guidance has been prepared with regard to the financial collateral principles set out in regulation 20(6) of the FCARs. The financial collateral principles (together, the **FCPs**) are that:

[15] An "appropriate body" is a body designated by HM Treasury under regulation 20(4), FCARs. A body may only be designated as an appropriate body if HM Treasury is satisfied that it has sufficient resources, knowledge and expertise to perform the functions of an issuer of approved guidance, namely: (1) to issue guidance on those matters set out in regulation 20(2); (2) to do so with regard to the "financial collateral principles" (as set out in regulation 20(6), FCARs); and (3) to publish the guidance in such manner that HM Treasury has approved as appropriate to bring it to the attention of persons likely to be affected by it.

[16] Guidance will be "approved guidance" if: (1) it is issued by HM Treasury with regard to the financial collateral principles; or (2) it is issued by an appropriate body with regard to the financial collateral principles and is approved by HM Treasury under regulation 20(5), FCARs.

[17] The exercise of this power supports a qualified "safe harbour" for market participants who use, or are considering the use of, financial collateral to secure or cover relevant financial obligations: see Section B of this Guidance under "Status". This aims to provide a material degree of legal certainty for participants when drafting the contractual terms, and designing the operational procedures, supporting their relevant collateral arrangements.

(1) a relevant administrative control arrangement[18] should be commercially useful and effective with a view to its practical operation in managing or reducing risk for the parties to the arrangement and third parties (**FCP1**);

(2) the administrative burdens for a collateral-taker under a relevant administrative control arrangement should be limited (**FCP2**);

(3) rapid and non-formalistic enforcement procedures should be available to a collateral-taker under a relevant administrative control arrangement with a view to safeguarding financial stability and limiting contagion effects upon the occurrence of an enforcement event (**FCP3**);

(4) the practical operation of a relevant administrative control arrangement should ensure a balance between market efficiency and the safety of the parties to the arrangement and third parties by minimising risk (including the risk of fraud) (**FCP4**); and

(5) the practical operation of a relevant administrative control arrangement should take into account the interest of the collateral-giver to dispose of, use or withdraw financial collateral in the relevant administrative control of the collateral-taker, where the collateral-taker agrees that the collateral is not required to secure or cover the relevant financial obligations owed to it (**FCP5**).

Status

9. Under regulation 20(7) of the FCARs, when determining whether financial collateral has been "provided" to a collateral-taker (or a person acting on its behalf) for the purpose of the FCARs, a court is required "to consider" the analysis and conclusions set out in this Guidance (as approved guidance) if relevant to the issue (that is, if relevant in the light of the specific facts, circumstances and arguments put before the court). We would emphasise that this Guidance cannot, however, bind a court - even if it is relevant to the court's determination of a particular matter.

10. This means that if a relevant collateral arrangement is structured so as to satisfy the conditions that we consider in this Guidance as necessary or sufficient to support the "provision" of financial collateral, it will not necessarily follow that a court will conclude that the collateral-giver has provided the relevant financial collateral to the collateral-taker (or a person acting on its behalf) for the purpose of the FCARs. Conversely, if a relevant collateral arrangement fails to meet such conditions, a court may still conclude that nevertheless the collateral-giver has indeed provided the relevant financial collateral for this purpose.

[18] A "relevant administrative control arrangement" is defined in regulation 3(1) of the FCARs. It is an agreement or arrangement, evidenced in writing, where: (1) the purpose of the agreement or arrangement is to secure the relevant financial obligations owed to the collateral-taker; (2) the collateral-giver creates or there arises a security interest in financial collateral to secure those obligations; (3) the financial collateral is in the relevant administrative control of the collateral-taker (or a person acting on its behalf); and (4) the collateral-giver and the collateral-taker are both non-natural persons. "Relevant administrative control" refers to the control of financial collateral by a collateral-taker (or a person acting on its behalf) effected by any of the steps taken in relation to the financial collateral described in regulation 3(2).

However, it is anticipated that as approved guidance is required to be issued by HM Treasury or other bodies who have appropriate resources, expertise and knowledge of matters that are relevant to the issue before the court and as market participants can be expected to have had regard to approved guidance when structuring their relevant collateral arrangements, this Guidance (as approved guidance) should be of persuasive effect for a court with regard to any issue on which views have been expressed in it[19].

C. General guidance on the approach to the interpretation of "provision"

"Relevant administrative control" – necessary, but not sufficient

11. Regulation 3(2) of the FCARs provides an exhaustive list of those operational or administrative arrangements in relation to financial collateral that must be put in place to establish "relevant administrative control" over the collateral and support its "provision" to the collateral-taker (or a person acting on its behalf) under a relevant administrative control arrangement. However, while relevant administrative control is a *necessary* condition[20] for the provision of financial collateral, it is *not sufficient* to result in the financial collateral the subject of the arrangement being "provided" for the purposes of the FCARs – unless the relevant administrative control arrangement is constituted as a security interest in favour

[19] We also consider that, in assessing the persuasive weight or value to be accorded to this Guidance, a court is likely to bear in mind that the relevant provisions of the FCARs, impacting on the "provision" of financial collateral, were made by the Treasury in exercise of its power to make regulations about relevant collateral arrangements under section 255 of the Banking Act 2009 and that this Guidance has been made under those regulations. Under its enabling power, the Treasury may make any provision that the Treasury thinks necessary or desirable: (1) for the purpose of, or in connection with, the implementation of the Financial Collateral Arrangements Directive; (2) for the purpose of enabling relevant collateral arrangements to be commercially useful and effective; and (3) to achieve or restore certainty and stability in connection with the matters to which the regulations made under the enabling power relate. The Treasury has concluded that the financial collateral principles properly reflect the policy considerations at the foundation of the s. 255 enabling power. However, it has also concluded that the granularity and nuanced nature of the practical issues relating to a determination as to whether or not financial collateral is "provided" under a particular relevant collateral arrangement does not, in all cases, readily allow for the resolution of those issues through legislative provisions. It is for this reason that it reserved the power to itself in Part 6 of the FCARs to make or approve guidance with regard to the financial collateral principles. The Treasury anticipated that such guidance would be able to achieve the statutory purposes behind the enabling power, which it concluded could not otherwise be achieved by the making of regulations alone. As this Guidance has been approved by the Treasury, the Treasury is satisfied that it is consistent with and promotes the statutory purposes behind the regulation-making powers delegated to it by Parliament under section 255 of the 2009 Act – whilst recognising that this Guidance itself, as approved guidance (and unlike regulations made by the Treasury under the enabling power) has not been the subject of further Parliamentary scrutiny in accordance with the affirmative resolution procedure set out in section 256.

[20] We believe that the policy judgement at the basis of the operational and administrative arrangements set out in regulations 3(2)(a) to (c)(iii), as types of relevant administrative control, relies on two fundamental protections for all relevant parties. First, if: (1) the collateral-taker has itself taken possession of the relevant instrument or a certificate of title relating to the financial collateral; or (2) the relevant financial collateral is credited to an account of the collateral-taker or held in its name in a register of financial instruments, then the collateral-taker has a material degree of operational control so as to minimise the risk that the collateral-giver (whether through its negligence, fraud or error) may dispose of the financial collateral to an innocent or co-fraudulent third party. This reduction of operational risk goes some way to achieving the same protections that might otherwise be afforded through the public registration of relevant particulars of the arrangement (with regard to FCP4). Second, if the financial collateral remains credited to an account of the collateral-giver, a control agreement or designating entry to which the relevant intermediary, CSD or account servicing institution is party or of which it has notice means that the fact of the relevant administrative control arrangement should be readily discoverable by a third party dealing with a party to the arrangement (upon enquiry of the intermediary, CSD or account servicing institution with, where necessary, the consent of the collateral-giver). This goes some way to satisfy the safety objective included within FCP4. However, these operational measures are not in themselves sufficient protections as the nature and extent of the contractual or other legal rights reserved by, or granted to, the collateral-giver in relation to the relevant financial collateral may: (a) largely vitiate the level of operational control that is in reality enjoyed by the collateral-taker over the collateral; and/or (b) fall outside the ambit of rights vested in a collateral-giver that might otherwise be reasonably suggested by a control agreement or designating entry operating in relation to the collateral.

of an intermediary, CSD or account servicing institution that has relevant administrative control of the financial collateral of the type described in regulation 3(2)(c)(iv)[21].

12. The FCARs refer to a relevant administrative control arrangement under which the collateral-taker (or a person acting on its behalf) has relevant administrative control of any of the types described in regulations 3(2)(a) to (c)(iii) (but not regulation 3(2)(c)(iv)) as a "Relevant Rights Arrangement". We will refer to a Relevant Rights Arrangement as an **RRA** in this Guidance. The designation of this type of relevant administrative control arrangement as a "Relevant Rights Arrangement" reflects the fact that, in accordance with regulation 3(3), under such an arrangement the issue as to whether the relevant financial collateral is provided is likely to be determined by whether the rights (if any) reserved by, or granted to, the collateral-giver in relation to the collateral are or are not *relevant rights* for the purposes of the FCARs. A relevant administrative control arrangement under which the collateral-taker has relevant administrative control of the type described in regulation 3(2)(c)(iv) is not an RRA because, in accordance with regulation 3(4), such relevant administrative control is itself sufficient to effect the provision of the relevant financial collateral to the collateral-taker (or a person acting on its behalf). In an arrangement of this type, in determining whether the relevant financial collateral has been provided, there is no further requirement to analyse the nature or effect of any rights that may be reserved by, or granted to, the collateral-giver in relation to the collateral.

13. Under regulation 3(3), the reservation by, or grant in favour of, the collateral-giver of "relevant rights" (as defined in regulation 3(1)) in relation to the financial collateral under a Relevant Rights Arrangement does not prevent the provision of that collateral to the collateral-taker (or the person acting on its behalf). It follows that if, under the Relevant Rights Arrangement, certain rights are reserved by, or granted to, the collateral-giver that are not "relevant rights", they *may* prevent the relevant financial collateral from being "provided". In this event, the Relevant Rights Arrangement will not be eligible for protection as an SFCA under the FCARs. This will be so even though the collateral-taker (or its agent) has relevant administrative control of the financial collateral.

The impact of rights that are not "relevant rights" on an RRA: a general test

14. Of course, the fact that a right which is reserved by, or is granted to, a collateral-giver under a Relevant Rights Arrangement is not a "relevant right" may not necessarily itself prevent

[21] Pursuant to regulation 3(4) of the FCARs, relevant administrative control of financial collateral in favour of an intermediary, CSD or account servicing institution of the type described in regulation 3(2)(c)(iv) *is* itself sufficient to ensure the provision of that collateral to the intermediary, CSD or account servicing institution. In such a case, even if rights are reserved by, or granted to, the collateral-giver in relation to the financial collateral which extend beyond "relevant rights" for the purposes of the Regulations, the financial collateral is not prevented from being provided to the relevant collateral-taker. If the arrangement with the intermediary, CSD or account servicing institution is a relevant administrative control arrangement, this relevant administrative control effecting the provision of the financial collateral will also be sufficient to ensure that the arrangement qualifies as, and receives the protections afforded to, an SFCA under the FCARs. We consider that this reflects a policy decision to recognise and encourage the integral role that intermediaries, CSDs and account servicing institutions play in the provision of credit and liquidity to support the financial markets and other operations of their account holders. Creditors and other third parties dealing with account holders can be expected to be on notice that such account holders are likely to have entered into credit and liquidity support arrangements with the relevant intermediary, CSD or account servicing institution. As a result, they should make such further enquiries as may be appropriate to understand the nature and extent of any relevant collateral arrangement that may have been entered into by the account holder to secure or cover relevant financial obligations owed to the relevant intermediary, CSD or account servicing institution under or in connection with the support arrangements.

the relevant financial collateral from being provided to the collateral-taker (or the person acting on its behalf). We consider that such a right should only have this effect if:

(1) the right is exercisable in relation to financial collateral which is, at any time at which the right may be exercised, securing or covering relevant financial obligations under the RRA;

(2) the exercise of the right affects, or may come to affect, any of the collateral-taker's rights, privileges and benefits (or its enjoyment of any of the rights, privileges and benefits) that would otherwise arise from or in connection with its relevant administrative control[22] of the financial collateral (or from such possession or control by a person acting on its behalf); and

(3) the exercise of the right as a relevant right, in accordance with the terms of the RRA, would not be consistent with any one or more of the financial collateral principles[23].

15. So, for example, any right reserved by, or granted to, the collateral-giver under an RRA:

(1) with respect to the steps that the collateral-taker must take to evidence or effect the termination or release of its title or interest in financial collateral upon or after discharge of the relevant financial obligations secured or covered by the RRA; or

(2) under the notices, governing law or submission to jurisdiction clauses of the RRA,

should not, in our view, impact upon the question as to whether the financial collateral the subject of the arrangement has or has not been provided to the collateral-taker (or a person acting on its behalf). Such rights do not have the features described in paragraphs [14(1) and (2)] above and so need no further analysis, in determining whether relevant financial collateral is provided, as to whether they may or may not be relevant rights under the FCARs.

"Relevant rights" – the statutory context

16. However, if a right reserved by, or granted to, a collateral-giver under an RRA does have the features described in paragraphs [14(1) and (2)] above, then in making any determination on the "provision" issue, it will be necessary to characterise that right as either a "relevant

---

[22] "Relevant administrative control" in relation to financial collateral refers here to the possession or control of the collateral by a collateral-taker (or a person acting on its behalf) which is effected by any of the steps taken in relation to the collateral described in regulation 3(2)(a) to (c)(iii) of the FCARs.

[23] We consider this test to be the natural corollary of the type of rights that qualify as relevant rights within paragraph (d) of the definition of "relevant rights" in regulation 3(1) of the FCARs. We believe that the thinking behind paragraph (d) is that, as the collateral-taker's relevant administrative control of the financial collateral should be readily discoverable by affected third parties, such third parties are entitled to expect (without more) that the RRA will possess all of the features which should be an incident of a relevant administrative control arrangement as described in the financial collateral principles. If, contrary to this expectation, the collateral-giver reserves or is given rights in relation to the financial collateral that (were they to be categorised as relevant rights and thereby make the arrangement an SFCA) would cause the RRA to operate in a manner which is inconsistent with any one or more of the financial collateral principles, then by their private agreement the parties are in effect taken to have accepted that the RRA should not be treated as an SFCA. Under the FCARs, the financial collateral the subject of the security interest is prevented from being provided and, in consequence, the protections afforded to an SFCA under the Regulations are denied to the RRA under which the collateral-giver has such rights.

right" (the existence or exercise of which does not prevent the provision of the relevant collateral) or a right the existence or exercise of which prevents the provision of the relevant collateral under the FCARs[24].

17. In carrying out this analysis, the FCARs direct that the assessment should be undertaken with regard to the financial collateral principles. This process is at the core of the reasoning that we set out in the rest of this Guidance in relation to certain types of right exercisable by a collateral-giver in relation to financial collateral in accordance with the terms of an RRA. However, we also consider it important in performing the analytical exercise in relation to an RRA to bear in mind the statutory context in which the exercise is being done. In particular, paragraphs (a) to (c) of the definition of "relevant rights" in regulation 3(1) of the FCARs describe specific rights of a collateral-giver in relation to financial collateral that qualify as relevant rights. In giving these examples, the draftsman of the FCARs has given a very clear indication as to the nature and scope of the rights that are capable of being relevant rights under the Regulations.

18. We believe that some general principles can be elicited from this list that might prove useful when seeking to determine the proper characterisation of a collateral-giver's right in relation to financial collateral under the terms of an RRA. These general principles are as follows.

    (1) The fact that the security intertest granted in favour of a collateral-taker is properly characterised as a floating charge (for example, by reference to the nature and scope of the rights of the collateral-giver in relation to the charged financial collateral under the RRA) will not, of itself, prevent the provision of the financial collateral. This is evident because it is likely that the reservation or grant of a number of the relevant rights listed in paragraphs (a) to (c) of the definition would cause the security interest under the RRA to be properly characterised as a floating charge under English law[25].

    (2) Separately, we consider this conclusion to be supported by limb (ii) in each of the definitions of "cash control agreement", "cash designating entry", "financial instruments control agreement" and "financial instruments designating entry" in regulation 3(1). These limbs contemplate that it is possible to provide financial collateral under an RRA in which the relevant administrative control of the

[24] It is also worth noting that as the only remaining condition that a Relevant Rights Arrangement must satisfy in order to qualify as an SFCA is whether the rights (if any) reserved by, or granted to, the collateral-giver in relation to the financial collateral are or are not relevant rights, the resolution of this issue will also determine whether the RRA will or will not attract the protections afforded to an SFCA under the FCARs.

[25] The leading authority on the nature of the test which must be carried out to determine whether a charge is or is not a floating charge is the decision of the House of Lords in *National Westminster Bank plc -v- Spectrum Plus Limited [2005] UKHL 41*. In this case, it was held that the essential characteristic of a floating charge is that, *"the asset subject to the charge is not finally appropriated as a security for the payment of the debt until the occurrence of some future event. In the meantime the chargor is left free to use the charged asset and to remove it from the security"*. On the basis of this test, it is probable that the rights of substitution and withdrawal of "excess" collateral set out in paragraph (c) of the definition would render the charge under the RRA to be a floating charge; and it is strongly arguable that the other rights described in paragraphs (a) and (b) of the definition are also consistent with the characterisation of the charge under the RRA as a floating charge.

collateral-taker (or a person acting on its behalf) shall only vest *"in such circumstances and as to such matters as may be provided"* by the RRA, account agreement or rules. We believe that this contemplates the circumstances in which a floating charge might crystallise and attach to specific financial collateral the subject of the relevant control agreement or designating entry.

(3) The collateral-giver may reserve, or have granted to it, rights in relation to financial collateral of material economic value without preventing the provision of the collateral to the collateral-taker (or a person acting on its behalf). We believe that the reasoning behind this policy position is that:

(a) it should ultimately remain a risk decision for the collateral-taker to determine the value and nature of the financial collateral that it wishes to retain in its relevant administrative control and that it is not possible for the collateral-giver to dispose of, use or withdraw from the collateral pool without the consent of, or further reference to, the collateral-taker (or a person acting on its behalf);

(b) accordingly, if prior to an enforcement event the collateral-giver is entitled to:

(i) exercise rights, privileges or benefits attached to or arising from the financial collateral;

(ii) dispose of, use or withdraw from the collateral pool the fruits of any such exercise; or

(iii) otherwise withdraw from the collateral pool assets subject to the security interest created under an RRA,

such a right should not prevent the provision of the financial collateral *<u>if</u>* the collateral-taker (or the person acting on its behalf) retains relevant administrative control of other financial collateral that, in accordance with its credit or other risk assessment, is in its view sufficient to collateralise its exposure; and

(c) it is in the interests of creditors of (and other third parties dealing with) the collateral-giver to develop an approach to the "provision" issue that encourages the use of RRAs under which the collateral-giver has ready access to valuable rights, privileges or benefits attached to or arising from the financial collateral, or otherwise to parts of the financial collateral pool, provided to the collateral-taker (or the person acting on its behalf) where the collateral-taker considers that its retention of those rights, privileges, benefits or collateral is not necessary to adequately collateralise its

exposure – and, as such, the reservation or grant of such access for the collateral-giver is consistent with, and promotes, FCP5[26].

Unqualified right of disposal or withdrawal

19. Applying these general principles, and having regard to the FCPs, we consider that a right reserved by, or granted to, the collateral-giver under a Relevant Rights Arrangement:

(1) to sell, transfer, withdraw or dispose[27] of the financial collateral the subject of the relevant security interest, without requiring the consent of or further reference to the collateral-taker (or a person acting on its behalf);

(2) where such right:

(a) is not the relevant right to substitute the financial collateral or to withdraw excess financial collateral; or

(b) does not relate solely to interest, income, dividends or other distributions payable or deliverable in respect of the financial collateral[28],

would be a right which is inconsistent with the provision of the financial collateral to the collateral-taker and, as such, cannot be a "relevant right" for the purposes of the FCARs.

20. To recognise an RRA as eligible for protection as an SFCA under the FCARs that includes an unqualified right of disposal or withdrawal for the collateral-giver would be contrary to FCP4 for the following reasons.

(1) Where the financial collateral is credited to an account in the name of the collateral-giver (but so as to remain in the relevant administrative control of the collateral-taker), there would be no evident or reasonably discoverable fact or circumstance to put a creditor of (or other third party dealing with) the collateral-taker on notice or enquiry that the interest of the collateral-taker in the financial collateral is readily terminable or defeasible by the collateral-giver (without requiring the consent of or

---

[26] As a general matter, in view of the limited amount and value of assets that may be freely available to a debtor to use as security for its obligations to a creditor, or otherwise to meet the claims of unsecured creditors, a principled approach to the concepts of "relevant rights" and "provision" as used in the FCARs should encourage RRAs which do not seek unduly or unnecessarily to fetter financial collateral to the exclusive use of a particular collateral-taker. If relevant rights, privileges, benefits and assets are not required by the collateral-taker in order to sufficiently collateralise its exposure, it would be wrong to discourage the free use by, or the free return to, the collateral-giver of those rights, privileges, benefits and assets. The free circulation of a collateral-giver's property, which the collateral-taker agrees is not required to secure or cover the relevant financial obligations owed to it, is in the wider economic interest and enlarges the asset pool that remains available to the collateral-giver for use in the ordinary course of its business. It is, therefore, sound policy to interpret the concepts of "relevant rights" and "provision" in a way that, while respecting the legitimate right of the collateral-taker to retain adequate financial collateral to secure its exposure (in accordance with its assessment of the relevant credit risk), does not militate against the reservation or grant of materially valuable rights for the collateral-giver to use or withdraw other property that is required by the collateral-giver for the efficient and effective undertaking of its business.

[27] However, for the reasons set out further below in this Guidance, we consider that a right to create (or permit to subsist) another security interest in financial collateral (otherwise provided to a collateral-taker), whether with or without the consent of the collateral-taker, should not itself prevent the provision of that collateral to the collateral-taker.

[28] The right to receive for the collateral-giver's own account (or instruct the collateral-taker or any other person to account for) such distributions is expressly recognised as a "relevant right" within paragraphs (a) and (b) of the definition contained in regulation 3(1).

further reference to the collateral-taker). In such a case, the existence of a control agreement or designating entry[29] with respect to the financial collateral would, at best, fail to suggest the nature and extent of the right of disposal or withdrawal that remains vested in the collateral-giver in relation to the collateral; and, at worst, could be positively misleading as to the nature and extent of such right.

(2) Where the financial collateral is held, or is credited to an account, in the name of (or is in the possession of) the collateral-taker (or a person acting on its behalf) so as to be under its relevant administrative control, there would be no evident or reasonably discoverable fact or circumstance to put a creditor of (or other third party dealing with) the collateral-taker on notice or enquiry that the interest of the collateral-taker is readily terminable or defeasible by unilateral action on the part of the collateral-giver[30]. As a result, such a creditor (or any other third party) might deal with the collateral-taker on the (mistaken) basis that the relevant financial obligations will at all relevant times remain secured or covered by the financial collateral (absent the re-delivery or re-transfer of the collateral with the consent of the collateral-taker or in exercise of a right of substitution or withdrawal of excess collateral).

21. In such cases, the safety considerations at the foundation of FCP4 would clearly favour the perfection of the RRA by registration of its terms and other relevant particulars of it in a public register (e.g. the Companies House register of charges). This would allow creditors of (and other third parties dealing with) the collateral-taker to inspect the register to investigate the true nature and scope of the collateral-giver's right of disposal or withdrawal in relation to the charged financial collateral, notwithstanding the fact that the collateral is in the relevant administrative control of the collateral-taker (or a person acting on its behalf). In this way it is registration of an RRA that includes such a right of disposal or withdrawal, and not relevant administrative control by or on behalf of the collateral-taker, that satisfies the risk management objective at the foundation of FCP4 and properly protects the interests of those third parties dealing with the collateral-taker. As a result, an RRA which reserves or grants to the collateral-giver such an extensive right of disposal or withdrawal should not qualify as an SFCA under the FCARs.

---

[29] Save where the relevant security interest is created in favour of the relevant intermediary, CSD or account servicing institution, it will be a necessary condition for such an arrangement potentially to qualify under the "provision" test for there to be a relevant control agreement or designating entry to establish relevant administrative control for the collateral-taker over the charged financial collateral: see regulation 3(2)(c)(ii), (iii) and (iv) of the FCARs and the analysis set out above under *""Relevant administrative control – necessary, but not sufficient"*.

[30] We believe it reasonable to proceed on the basis that a creditor (or other third party) dealing with the collateral-taker, who holds or possesses the financial collateral under a security interest, should be considered to have notice of the limited nature of that interest (i.e. as something less than full ownership of the collateral). This conclusion follows, in our view, from the express recognition by the FCARs of the rights of substitution and to withdraw excess collateral as relevant rights, even if the financial collateral the subject of the relevant security interest is held or possessed by (and so as to be in the relevant administrative control of) the collateral-taker. If these relevant rights can be an incident of the provision of financial collateral under an SFCA, even where the financial collateral is held or possessed by the collateral-taker, then third parties should not be entitled to assume that such a holding or possession is indicative of full beneficial ownership to the assets in the collateral-taker.

Practical aspects of consent given by the collateral-taker

22. It is clear from the definitions of "control agreement" and "designating entry" in regulation 3(1) of the FCARs that an RRA may qualify as an SFCA where the collateral-taker has only taken "positive" control over the collateral credited to an account in the name of the collateral-giver (or a person acting on its behalf), i.e. where, as against the relevant intermediary, CSD or account servicing institution, the collateral-taker has the power to instruct the withdrawal or transfer of the collateral in such circumstances and as to such matters as may be specified. This type of relevant administrative control is not "negative" control because it cannot itself prevent the relevant intermediary, CSD or account servicing institution from complying with instructions from the collateral-giver in relation to financial collateral credited to the collateral-giver's account (or an account of a person acting on the collateral-giver's behalf). This may be an efficient and administratively convenient operational arrangement as, prior to an enforcement event, it would not require the collateral-taker to be involved in the management or other operation of the relevant account as against the relevant intermediary, CSD or account servicing institution[31].

23. In our view, such an RRA is capable of qualifying as an SFCA *if*:

    (1) as between the collateral-giver and the collateral-taker, the collateral-giver (or the person acting on its behalf) could only give such instructions to the relevant intermediary, CSD or account servicing institution with the prior consent and under the authority of the collateral-taker; and

    (2) the collateral-taker's contractual or other legal rights entitle it to prevent the disposal or withdrawal of financial collateral by the collateral-giver where the collateral-taker considers it necessary or appropriate to preserve the collateral pool available to it for realisation (upon an enforcement event).

24. Such consent or authority of the collateral-taker may be given on a case-by-case basis in response to a specific request from the collateral-giver to whose account (or to whose agent's account) the financial collateral is credited[32]. The RRA would need to operate subject

[31] In our examination of the practical aspects of consent, and our subsequent analysis of the rights of substitution, withdrawal of excess collateral and withdrawal on the collateral-taker's insolvency (in Sections D, E and F of this Guidance), we focus on the scenarios where the relevant financial collateral remains credited to an account in the name of the collateral-giver (albeit under the relevant administrative control of a collateral-taker or a person acting on its behalf). This is because, in practice, where the collateral is credited to an account in the name of the collateral-taker (or a person acting on its behalf), we would expect the type of risk management controls that we describe in this Guidance to be applied as a practical incident of the relevant administrative control that vests in the collateral-taker (or the person acting on its behalf) by virtue of the credit of financial instruments or cash to its account. However, it is important to emphasise that we consider it would be essential for such risk management processes (designed to ensure that the collateral-taker can effectively monitor the collateral-giver's use of collateral so as to prevent such use from leaving the collateral-taker insufficiently collateralised) to operate as a practical matter, even when the collateral is credited to an account in the name of the collateral-taker (or a person acting on its behalf). If this is not the case, we consider it likely that any right of the collateral-giver to use or dispose of the collateral would prevent the provision of such collateral to the collateral-taker (or a person acting on its behalf) for the purpose of the FCARs.

[32] Such consent or authority may require an "active" response from or on behalf of the collateral-taker to each request, so that no disposal or withdrawal may be effected by or on behalf of the collateral-giver without specific approval. Alternatively, a "passive" response may be sufficient if it is agreed that, if no objection is received from the collateral-taker (or the person acting on its behalf) within a reasonable period, such consent or authority shall be treated as given to the disposal or withdrawal. However, in either case, it would be necessary to ensure that the collateral-taker (or the person acting on its behalf) is effectively monitoring the withdrawal or disposal of financial collateral under the arrangement. This risk management process would be undertaken with a view to ensuring that the collateral-giver is

to effective monitoring by or on behalf of the collateral-taker to ensure that, first, any subsequent disposal was effected in accordance with the given consent or authority; and, second, after any such disposal sufficient collateral remains at all times available to the collateral-taker to a value (and quality) that accords with the collateral-taker's requirements under its credit assessment of the collateral-giver (or, if different, the debtor).

25. It might also be possible, of course, for a collateral-taker to give a "standing" consent or authority to the collateral-giver to instruct the disposal or withdrawal of the collateral under an RRA from the collateral-giver's (or its agent's) account, but make such consent or authority subject to the satisfaction of, or compliance by the collateral-giver (or a person acting on its behalf) with, specified conditions. This is the basis of the right of substitution or to withdraw excess financial collateral discussed in Sections D and E of this Guidance, but potentially allows for wider relevant rights to be reserved by, or granted to, a collateral-giver. We consider that such an arrangement is also capable of supporting the categorisation of the collateral-giver's power of disposal or withdrawal as a "relevant right" under an RRA, but *only if*:

    (1) the specified conditions are designed to ensure that sufficient financial collateral (as determined by the collateral-taker) will remain under its relevant administrative control to secure or cover the relevant financial obligations under the RRA (e.g. the specified conditions may relate to the type or quality of financial instruments that must remain in the collateral-giver's account, allowing for the disposal or withdrawal by the collateral-giver of financial collateral that is not of the identified type or quality);

    (2) (in a similar way to the right of substitution and to withdraw excess financial collateral discussed in Sections D and E respectively) a suitable risk management process is put in place, and in practice operated, under which the collateral-taker (or a person acting on its behalf) has the ability, with access to sufficient information: (a) to verify in good time whether a proposed disposal or withdrawal is consistent with the specified conditions, and (b) effectively to monitor whether, in fact, the account to which the financial collateral is or was credited is being operated in a manner consistent with any notifications or approvals given, or refusals notified, under the risk management procedures; and

    (3) the collateral-taker has the right to prevent any proposed disposal or withdrawal of collateral (and the collateral-giver agrees that it shall not instruct the disposal or withdrawal) if the collateral-taker (or a person acting on its behalf) determines (in

---

acting in compliance with any consent or authority so given; and the collateral-giver is not able to use financial collateral if that would leave the collateral-taker insufficiently collateralised (as determined in accordance with the requirements of the collateral-taker under its relevant risk assessment).

good faith and in a commercially reasonable manner[33]) that the disposal or withdrawal would be inconsistent with the specified conditions.

26. We believe such a right of disposal or withdrawal for a collateral-giver in an RRA, which must operate subject to the risk management processes we outline above, is properly characterizable as a "relevant right". The exercise of the right as a relevant right, in accordance with the terms of the RRA, is consistent with both FCP4 and FCP5.

27. As far as FCP4 is concerned, the operational risks attendant upon the relevant administrative control effected over financial collateral that remains credited to an account of the collateral-giver (or a person acting on its behalf) is appropriately mitigated by risk management controls designed to prevent the innocent, negligent or fraudulent disposal or withdrawal of financial collateral that might otherwise leave the collateral-taker insufficiently collateralised. This adequately addresses any potential concerns that creditors of (or other third parties dealing with) the collateral-taker may be misled as to the nature or extent of the financial collateral that should remain available to the collateral-taker to secure or cover its relevant financial obligations in the event of default by the collateral-giver (or, if different, the debtor).

28. As far as FCP5 is concerned, for the reasons we explored above under *""Relevant rights – the statutory context"*, it is clearly in the interests of the collateral-giver (and any third parties dealing with it), that the collateral-giver should have ready access to and use of financial collateral credited to its account that is not required by the collateral-taker to collateralise the relevant financial obligations (as determined in accordance with the terms of the RRA and the collateral-taker's own credit or other risk assessment of its exposure)[34].

Right to create, or permit to subsist, another security interest

[33] We consider that an appropriate level of responsibility should be accepted by the determining party to the collateral-giver as to whether or not the relevant release conditions are satisfied. This should ensure that the RRA, under which the right to use or withdraw is exercisable, continues to operate in a manner which is consistent with FCP5. The collateral-taker has agreed that, subject to the satisfaction of the relevant release conditions, the relevant financial collateral is not required by it to act as security or cover for the relevant financial obligations owed to it. The contractual duty to make any determination in good faith and in a commercially reasonable manner should prevent any arbitrary or wrongful refusal to the release of collateral that the collateral-giver requires for use in the course of its business.

[34] Although we have focused on the consistency with FCP4 and FCP5 of an RRA under which the collateral-taker has relevant administrative control over financial collateral credited to the collateral-giver's (or its agent's) account and where the collateral-giver may dispose or withdraw of the collateral subject to the risk management procedures described, it is also evident that the qualification of the rights of the collateral-giver as "relevant rights" in such a case is also consistent with, the other financial collateral principles. We consider that the operation of such rights and related risk management processes to be a practical, efficient and effective solution to meet and balance the respective interests of the collateral-giver (and third parties dealing with it) and of the collateral-taker (and third parties dealing with it). As such, we would expect the ready adoption of RRA structures that utilise this financial collateral solution with a view to ensuring the qualification of the relevant RRA as an SFCA, and so as to attract the relevant protections made available to SFCAs under the FCARs. This would, amongst other things, enable a wider range of RRAs to be commercially useful and effective with a view to their practical operation in managing or reducing risk for the parties to the RRA and third parties (with regard to FCP1); would limit the administrative burdens for collateral-takers under such RRAs (with regard to FCP2); and provide a rapid and non-formalistic enforcement procedure for collateral-takers under such RRAs to safeguard financial stability and limit contagion effects (with regard to FCP3).

29. A right reserved by[35], or granted to, the collateral-giver to create (or allow to subsist) another security interest over financial collateral in which a collateral-taker has a security interest should not itself prevent the provision of the collateral to the collateral-taker. This should be the position irrespective of whether such a security interest can be created without the consent of the collateral-taker; and irrespective of whether the second security interest ranks, in terms of priority, ahead of or behind the security interest created by the relevant administrative control arrangement.

30. This conclusion is founded primarily on an analysis of regulation 3(2) of the FCARs. It provides an exhaustive list of those operational or administrative arrangements that effect "relevant administrative control" of financial collateral by or on behalf of the collateral-taker. Relevant administrative control is a necessary element in the provision of the collateral. In terms, the regulation clearly contemplates that the same financial collateral may be under the relevant administrative control of, and therefore potentially provided to, two or more different collateral-takers. For example, in accordance with paragraph (c) of regulation 3(2), cash collateral which is credited to an account of the collateral-giver may be in the relevant administrative control of both:

    (1) a collateral-taker under a relevant control agreement between the account servicing institution, that collateral-giver and the collateral-taker (see sub-paragraph (ii)); and

    (2) to the account servicing institution (as a collateral-taker) pursuant to a security interest created over the credit balance in favour of that institution (see sub-paragraph (iv)).

    There is nothing in regulation 3(2) to suggest that the relevant administrative control of, or the effective provision of financial collateral to, one collateral-taker is conditional either upon: (a) the obtaining of consent from another collateral-taker who also has relevant administrative control of the same financial collateral, or (b) the absence of relevant administrative control of the same collateral by another collateral-taker (or a person acting on its behalf).

31. If this is the position as between two or more security interests where in each case the collateral is in the relevant administrative control of (and has been provided to) each collateral-taker, there is in our view no logical or policy reason to reach a different conclusion as between, on the one part, a security interest in financial collateral which has been provided to the collateral-taker; and, on the other part, a security interest in the same financial collateral which not been provided to another collateral-taker (and where the security interest has, for example, been perfected by registration). The right to create a separate security interest in the same financial collateral, which is perfected by registration

[35] In practice, such a right is likely to be reserved "by omission". The power to grant a second security interest over the financial collateral will be a necessary incident of the collateral-giver's residual proprietary interest in the financial collateral, i.e. its equity of redemption. In the absence of a contractual prohibition on allowing to subsist, or creating, another security interest in the financial collateral in the terms of the relevant administrative control arrangement itself, the collateral-giver will have this right.

rather than its provision, should not prevent the same collateral being in the relevant administrative control of (and being provided to) a different collateral-giver under a relevant administrative control arrangement.

32. In essence, we consider the issue of competing security interests in the same financial collateral to be one of priority; and not one relating to the effectiveness or validity of a collateral-giver's provision of the collateral to a collateral-taker or the perfection of that collateral-taker's security interest through its provision. The relative priority between two or more security interests in the same financial collateral (whether perfected by provision or registration) would be determined by the applicable priority rules under general law.

33. To the extent relevant administrative control arrangements used in the financial markets typically include such rights for collateral-givers, this conclusion is consistent with FCP1; and, as relevant administrative control arrangements that are SFCAs benefit from the protections afforded by the FCARs, supports both FCP2 and FCP3. We also consider that to the extent the same asset or property of a collateral-giver has a value sufficient to act as security or cover for two or more security interests, it is economically efficient to allow or encourage the collateral-giver fully to use its asset or property to obtain secured credit in the interests of its business and third parties dealing with the collateral-giver (with regard to FCP5). If the ability to create (or permit to subsist) another security interest in the same financial collateral prevented the provision of the collateral to a collateral-taker under the FCARs, this would potentially encourage the collateral-taker to prohibit such additional security interests (so as to protect the qualification of its relevant administrative control arrangement as an SFCA). At a policy level this would be an undesirable result, especially where there remains sufficient equity in the financial collateral for the collateral-giver to allow for the further use of the relevant asset or property to obtain additional secured credit (at a better rate of interest than is likely to be obtainable on an unsecured basis)[36].

34. On the basis of this analysis, we conclude that a right reserved by, or granted to, a collateral-giver to create (or permit to subsist) a separate (prior or subsequent-ranking) security interest in financial collateral (the subject of a security interest under a Relevant Rights Arrangement) is properly categorised as a "relevant right" for the purposes of the FCARs. This is the case irrespective of whether the right is exercisable with or without the consent of the collateral-taker to whom the financial collateral is provided. The inclusion of such a right in or in relation to an RRA should not by itself, therefore, disqualify that arrangement as an SFCA.

35. If the reservation or grant of a right to create (or permit to subsist) another security interest in the same financial collateral does not prevent the provision of the collateral to a collateral-taker with relevant administrative control under an RRA, it must follow that the

[36] For completeness, we should add that we have not identified any issue with the exercise of the right to create (or permit to subsist) another security interest as a relevant right with regard to FCP4. Any safety or operational risk issues that might arise with respect to the creation of two or more security interests in the same financial collateral are adequately mitigated through the general law on the priority of security interests and the duties owed in equity by a collateral-taker with a first-ranking security interest to collateral-takers with subsequent-ranking security interests.

enforcement of any rights with respect to the collateral by that other collateral-taker pursuant to its own (permitted) security interest (including, where it is a prior-ranking security interest) should not itself prevent the provision of that collateral to the collateral-taker under the RRA (including, where it has a subsequent-ranking security interest in the collateral). It would be illogical to conclude that, while a right to create (or permit to subsist) another security interest in the same financial collateral is a relevant right, the exercise of that right by the collateral-giver so as to create (or permit to subsist) another security interest in the same collateral in favour of a different collateral-taker (or the enforcement of the rights under the security interest so created or permitted to subsist) should prevent the provision of the collateral to the collateral-taker under the RRA. Such a conclusion would negate the textual analysis, and policy basis, supporting our view that a right under an RRA to create (or permit to subsist) another security interest in the same financial collateral is properly characterised as a relevant right.

36. However, the exercise by the collateral-giver of rights with respect to financial collateral which are "relevant rights" as against a collateral-taker with, say, a prior-ranking security interest in the collateral could, without more, prevent the provision of that same financial collateral to a collateral-taker with a subsequent-ranking security interest in the collateral under an RRA. For example, if the collateral-giver is entitled (without reference to the subsequent-ranking collateral-taker) to withdraw collateral which is excess collateral as between it and the prior-ranking collateral-taker, such a right would be a relevant right as against the prior-ranking collateral-taker. But it is unlikely to be a relevant right as against the subsequent-ranking collateral-taker. This is because it would allow the collateral-giver to remove financial collateral from the security pool available to the subsequent-ranking collateral-taker without any determination as to whether such collateral is in fact excess collateral as between it and that collateral-taker. As such, the collateral-giver may have reserved, or had granted to it, as against that collateral-taker a right of disposal which is inimical to the categorisation of that right as a relevant right as between it and the subsequent-ranking collateral-taker under the RRA.

37. In such a case, the key determinant will be whether the subsequent-ranking collateral-taker under the RRA has itself reserved separate and additional legal and operational negative control over the financial collateral such that any right reserved by, or granted to, the collateral-giver to withdraw the financial collateral can properly be categorised, as between it and the subsequent-ranking collateral-taker, as a relevant right. In the example given above, this would require the collateral-giver to satisfy ***both***:

    (1) the relevant "excess financial collateral" requirement agreed with the prior-ranking collateral-taker; ***and***

    (2) a relevant "excess financial collateral" requirement agreed with the subsequent-ranking collateral-taker or some other effective control procedure under the RRA consistent with the characterisation of the collateral-giver's right of withdrawal as against that collateral-taker as a relevant right,

    before the collateral-giver is entitled to withdraw the collateral from the security pool.

D. The right of substitution

Approach to the issue

38. The right to substitute financial collateral (in the form of cash or financial instruments) of the same, equivalent or greater value or amount is specified as a "relevant right" by paragraph (c)(i) of the definition in regulation 3(1) of the FCARs. This right may be exercisable in relation to financial collateral that is under the relevant administrative control of the collateral-taker by, for example, being credited to its account (or an account of a person acting on its behalf) or, in relation to financial collateral that remains credited to an account of the collateral-giver, the putting in place of a control agreement in relation to the collateral.

39. The nature of the actual operational arrangements that might support the exercise of a right of substitution is varied. Where a court is considering whether or not a particular right of substitution before it does or does not prevent the provision of financial collateral to the collateral-taker under an RRA, it is likely to be appropriate therefore for the court to determine whether the specific operation under the RRA could properly be considered to have been in the reasonable contemplation of the draftsman of the FCARs.

40. In our view, if the actual operational arrangements that support a right of substitution under an RRA do not cause that right as a relevant right to be exercised in a manner which is inconsistent with any one or more of the FCPs, they can properly be considered to have been within the reasonable contemplation of the draftsman and, therefore, the related right of substitution remains properly characterizable as a "relevant right".

Valuation: specific operational considerations

41. It is common for the operational arrangements that support the exercise of rights of substitution in the UK's financial markets to permit or require the collateral-giver (or a person acting on its behalf) to determine the value of the financial collateral that is to be withdrawn from the RRA and the value of the collateral to be posted in substitution for that collateral.

42. This operational consideration gives rise to the concern that, whether through fraud, negligence or error, exercise of the right of substitution in such circumstances could unexpectedly (from the perspective of the collateral-taker or third parties dealing with it), and as a unilateral power on the part of the collateral-giver, materially deplete the actual value or amount of the financial collateral that secures the relevant financial obligations under the RRA.

43. In the absence of any residual risk management measures reserved to the collateral-taker (or a person acting on its behalf) to prevent or minimise the risk of this result, we consider that under an RRA containing such an unqualified right of valuation for the collateral-giver, it would be unlikely that the right of substitution supported by such a valuation mechanism would qualify as a relevant right for the purposes of the FCARs. The fraud and other

operational risks associated with such a right of substitution appear to us to be inconsistent with the safety considerations the basis of FCP4.

44. However, we consider that if the following minimum risk management measures are included in or in relation to an RRA[37] with respect to the valuation power of a collateral-giver exercising its right of substitution, it would remain appropriate to categorise the substitution right as a relevant right for the purposes of the FCARs:

(1) any valuations made by the collateral-giver must be verified by the collateral-taker or a third party (e.g. a custodian with whom the financial collateral is held) before the right of substitution may be exercised; or

(2) the collateral-taker must be able[38] to carry out such verification (or procure that it is carried out by a third party) and veto any exercise of the right of substitution if the collateral-giver's valuations cannot be confirmed or verified;

and, in either case:

(3) the person carrying out any such verification exercise must:

(a) be entitled to receive, and have, sufficient information about any proposed substitution (together with the relevant valuations) in good time before the proposed substitution to be able properly to investigate the position and complete its verification of the valuations (with regard to its contractual or other legal obligation described in paragraph (c) below);

(b) have the technical expertise to assess the validity of the collateral-giver's determinations; and

(c) assume or otherwise be subject to a contractual or other legal obligation[39]:

---

[37] It would be necessary for such measures to operate both: (1) as a matter of contractual or other legal obligation on the part of the collateral-giver (or the person acting on its behalf) and contractual or other legal right for the collateral-taker (or the person acting on its behalf); and (2) in practice (i.e. the relevant contractual or other legal risk management measures must be complied with by all relevant parties at all material times).

[38] We emphasise that the test here is the ***ability*** of the collateral-taker (as a matter of contractual or other legal righ) to verify the collateral-giver's determinations on each occasion of the collateral-giver's exercise of the right of substitution. For this purpose, sufficient notice of a proposed substitution of financial collateral must be given to the collateral-taker to give it time to determine whether (if at all) it wishes to undertake (or procure the undertaking of) a verification exercise with respect to the proposed substitution. The right must be one "of substance" and not just "in form". The surrounding circumstances of the exercise (or non-exercise) of the right during the period the RRA is operative must not lead to the conclusion, on an objective assessment of the relevant facts, that there has been a contractual variation or waiver of that right by the parties; or that the contractual-taker is estopped from exercising the right or power on any given occasion; or that the documented contractual arrangements are a "sham" that do not represent the true agreement of the parties. Subject to these "substance over form" considerations, it can properly remain a risk management decision for the collateral-taker to determine whether, on any given occasion, it wishes to exercise its right of verification with respect to a particular proposed substitution of collateral.

[39] We consider the imposition of such a contractual or other legal duty (and the related requirement for suitable technical expertise on the part of the verification body) to be appropriate to ensure that the associated right of substitution operates in a manner consistent with the safety of the parties to the RRA and to minimise risks, including the risk of fraud (with regard to FCP4); and in a manner that protects the interest of the collateral-giver in the financial collateral (with regard to FCP5) by minimising the risk that the collateral-giver could be improperly prevented from using or withdrawing financial collateral that it might need in the ordinary course of its business.

(i) (where that person is the collateral-taker) to the collateral-giver; or

(ii) (where that person is a third party) to the collateral-taker and the collateral-giver,

to carry out that exercise in good faith and in a commercially reasonable manner; and

(4) the collateral-taker (or a person acting on its behalf) must have the right to take effective steps to monitor whether the collateral-giver (or a person acting on its behalf) is in practice maintaining and operating the account to which the relevant financial collateral is or was credited in a manner consistent with any notifications or approvals given, or refusals notified, pursuant to the risk management measures.

45. In our view, these minimum risk management procedures are sufficient to ensure that a collateral-giver's right of substitution under an RRA, supported by a valuation mechanism in which it (or a person acting on its behalf) determines the value of the collateral, remains a relevant right for the purposes of the FCARs. They provide a solution that ensures that the exercise of the right of substitution as a relevant, in accordance with the terms of the RRA, is consistent with the financial collateral principles. Specifically, the procedures, in reflecting good market practice and ensuring the RRA continues to qualify as an SFCA, operate consistently with FCP1, FCP2 and FCP3; consistent with FCP4, they constitute a process that ensures an appropriate balance between market efficiency and the safety of all relevant parties by minimising risk (including the risk of fraud); and they take into account the interest of the collateral-giver to withdraw financial collateral that it may require in its business upon substitution of financial collateral that (in accordance with a fair and reasonable valuation exercise) is of the same, equivalent or greater value (consistent with FCP5).

46. In addition, a collateral-giver (or its custodian) under an RRA will typically retain a valuation role because financial collateral is, in practice, increasingly retained in an account in the name of the collateral-giver (or a person acting on its behalf)[40]. This reflects participant practice in certain important financial markets and responds to the concern, since the financial crisis of 2008, that collateral posted to the collateral-taker may not be returned promptly (or at all) in the event of the collateral-taker's insolvency. To allow a suitably risk-mitigated valuation role for a collateral-giver (or its custodian) under an RRA would, therefore, support accepted, efficient and effective market practices that are designed themselves to manage risk. This further supports our analysis that the operation of the right

[40] Regulatory requirements also encourage the retention of financial collateral under an RRA in an account in the name of the collateral-giver (or a person acting on its behalf). For example, the segregation requirements for non-centrally cleared OTC derivative contracts require initial margin "*to be freely transferable to the posting collateral-giver in a timely manner in case of the default of the collecting collateral-taker*": see Article 19(1)(g) of Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing Regulation (EU) No. 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty.

of substitution under an RRA, within the framework of the risk management mechanism outlined above, is consistent with the financial collateral principles.

E. The right to withdraw excess collateral

Approach to the issue

47. In a similar way to the right of substitution examined in Section D above, the right to withdraw excess collateral is specified as a "relevant right" by paragraph (c)(ii) of the definition in regulation 3(1) of the FCARs; the right is likely, in practice, to be subject to a variety of supporting operational models under RRAs; and, therefore, it is legitimate to determine whether the commonly used models supporting the right to withdraw excess collateral under an RRA do not cause its exercise as a relevant right to be inconsistent with any one or more of the FCPs, so that they can properly be considered to have been in the reasonable contemplation of the draftsman[41].

Valuation: specific operational considerations

48. In the same way as those operational arrangements that are put in place to support the exercise of a right of substitution, it is common for such operational arrangements that support the exercise of the right to withdraw excess collateral in the UK's financial markets under an RRA to permit or require the collateral-giver (or a person acting on its behalf) to determine the value of the financial collateral that is to be withdrawn from the RRA as being "in excess" of the relevant financial obligations.

49. In addition, such arrangements typically permit or require the collateral-giver to determine the value of the relevant financial obligations if these are not readily observable (for example, when they have an uncertain or fluctuating value).

50. On the basis of the same reasoning and analysis set out in Section D with respect to the right or obligation of the collateral-giver to value collateral in connection with the right of substitution, we consider that operational arrangements supporting a collateral-giver's right to withdraw excess collateral (under which the collateral-giver is permitted or required to value the withdrawable collateral and/or the relevant financial obligations with respect to which an "excess" is claimed or determined to arise) will support the right as a "relevant

[41] As explained in Section D, we consider that the operational arrangements that in practice support a right, which is specifically set out in paragraph (c) of the definition of "relevant rights" in regulation 3(1), would only have been in the reasonable contemplation of the draftsman of the FCARs if those arrangements support the exercise of the right in a manner which is not inconsistent with any one or more of the financial collateral principles. If they operate in a manner which is inconsistent with any one or more of the FCPs, our analysis and conclusion is that they render the right outside the scope of the "relevant rights" allowed for by the FCARs. In consequence, the relevant collateral the subject of the right under an RRA will not be "provided" and the RRA, under which the collateral is made the subject of a security interest, will not qualify as an SFCA.

right" *only if* the following minimum risk management measures[42] are included in or in relation to the RRA concerned:

(1) any valuation (whether as to the collateral to be withdrawn or the relevant financial obligations) made by the collateral-giver must be verified by the collateral-taker or a third party (e.g. a custodian with whom the financial collateral is held); or

(2) the collateral-taker must be able[43] to carry out any such verification (or procure that it is carried out by a third party) and veto any exercise of the right to withdraw excess collateral if the collateral-giver's valuation cannot be confirmed or verified;

and, in either case:

(3) the person carrying out any such verification exercise must:

(a) be entitled to receive, and have, sufficient information about any proposed withdrawal (together with the relevant valuations) in good time before the proposed withdrawal to be able properly to investigate the position and complete its verification of the valuations (with regard to its contractual or other legal obligation described in paragraph (c) below);

(b) have the technical expertise to assess the validity of the collateral-giver's determinations; and

(c) assume or otherwise be subject to a contractual or other legal obligation[44]:

(i) (where that person is the collateral-taker) to the collateral-giver; or

(ii) (where that person is a third party) to the collateral-taker and the collateral-giver,

to carry out that exercise in good faith and in a commercially reasonable manner; and

(4) the collateral-taker (or a person acting on its behalf) must have the right to take effective steps to monitor whether the collateral-giver (or a person acting on its behalf) is in practice maintaining and operating the account to which the relevant

[42] As explained in relation to the qualifying risk management measures that operate in support of the right of substitution, the corresponding measures that operate in support of the right to withdraw excess collateral would be required to operate: (1) as a matter of, and subject to, contractual or other legal rights/obligations of the parties; and (2) as a matter of practice at all material times.

[43] On the *ability* of the collateral-taker (as a matter of contractual or other legal right or power) to verify the collateral-giver's determination on each occasion of the collateral-giver's exercise of the right to withdraw excess collateral, see our analysis in Section D on the corresponding point with respect to the verification mechanism relating to the right of substitution.

[44] On our reasoning behind the imposition of such a contractual or other legal duty (and the related requirement for suitable technical expertise on the part of the verifying body), see our analysis in Section D on the corresponding point with respect to the verification mechanism relating to the right of substitution.

financial collateral is or was credited in a manner consistent with any notifications or approvals given, or refusals notified, pursuant to the risk management measures.

The meaning of "excess" financial collateral

51. The FCARs do not provide a definition of "excess" financial collateral that a collateral-giver may withdraw without undermining the eligibility of an RRA as an SFCA. There are two potential competing interpretations: first, excess must be determined by reference to the value of the secured obligations owed to the collateral-taker (so that an excess only arises where the value of the collateral exceeds the value of those secured obligations); or, second, excess must be determined by reference to an amount that the parties have agreed in the RRA must be collateralised.

52. For the reasons we explored in paragraph [18(3)] of this Guidance, we believe that the FCARs recognise that it should properly remain a risk decision for the collateral-taker under an RRA to determine the level of collateral it requires adequately to secure its exposure to the collateral-giver (or, if not the collateral-giver, the debtor). A collateral-taker may specify that the value of the collateral that it requires at all times to be in its (or its agent's) relevant administrative control must not be less than a specified percentage of the secured obligations owed to it, or not less than a specified sum or an amount determined by reference to a formula or other criteria agreed between the parties[45].

53. In our view, and with regard to the FCPs, we consider that the fact that the collateral-giver under an RRA has a right to withdraw collateral to the extent that it exceeds this specified value, sum or amount should not prevent the collateral being "provided" for the purpose of the FCARs. In other words, an "excess" arises where the value[46] of the collateral in the relevant administrative control of the collateral-taker (or a person acting on its behalf) under an RRA exceeds the value of the collateral that is required to be posted and maintained in accordance with the terms of agreement between the collateral-giver (or, if different, the debtor) and the collateral-taker. Any RRA that includes such a right to withdraw excess financial collateral should qualify as an SFCA and the protections afforded by the FCARs to SFCAs should apply to it.

54. Before turning to our analysis under the FCPs, we should note that it would be possible to structure an RRA to be consistent with both interpretative approaches to the "excess" collateral issue outlined in paragraph [51] above[47]. For example, an RRA might define the

[45] This may involve either an "over-collateralisation" of the collateral-taker's exposure (e.g. the required collateral value may be set at 110% of the value of the secured obligations owed to the collateral-taker) or an "under-collateralisation" (e.g. the required collateral value may be set at 90% of the value of the secured obligations owed to the collateral-taker). An under-collateralisation may occur, for example, where the collateral-taker has recourse to other forms of collateral (that is not financial collateral), guarantees or other assurances in respect of the secured obligations.

[46] As we have analysed above, the value of the collateral that is in "excess" of the specified required collateral amount may be determined by the collateral-giver itself (or a person acting on its behalf), subject to the operation of the risk management procedures we have described above to ensure that the right that is supported by the procedures operates as a relevant right in a manner which is consistent with the financial collateral principles.

[47] In our view, the fact that it would be readily possible to structure an RRA to satisfy both interpretative approaches further supports the conclusion that the correct approach is to regard an "excess" of collateral to arise where there is collateral with a value that is greater

relevant financial obligations secured or covered by it as being, say, 90% of the value of the obligations that are at any time owed to the collateral-taker under specified transactions[48]. If the collateral-giver is then entitled to withdraw financial collateral that leaves remaining collateral in the relevant administrative control of the collateral-taker (or a person acting on its behalf) with a value of at least 90% of the value of the obligations under the specified transactions, then the "excess" has arisen both because the value of the collateral held exceeds the value of the relevant financial obligations and because the value of the collateral exceeds the amount of collateral that that parties have specified must be held by or for the collateral-taker.

55. Irrespective of how the terms of any particular RRA might be structured to define the relevant financial obligations secured or covered by it, we consider that our preferred interpretative approach (under which an "excess" arises where the value of the collateral in the relevant administrative control of the collateral-taker exceeds an amount or value specified in the RRA) is consistent with the financial collateral principles for the following reasons.

    (1) In the case of both an "under-collateralisation" and an "over-collateralisation" RRA, this approach allows arrangements that typically operate in the financial markets in support of RRAs to continue to do so with the benefit of the protections afforded to SFCAs under the FCARs. This promotes the policy considerations at the foundation of FCP1, FCP2 and FCP3[49].

    (2) There is nothing in the operation of an "under-collateralisation" RRA that is inconsistent with the safety or risk considerations at the foundation of FCP4. As creditors (and other third parties) dealing with the collateral-taker should expect the decision as to the level of collateralisation to be determined as a risk decision of the collateral-taker alone, and that level of collateralisation to be specified by the

---

that the amount specified by the RRA (even if that amount is less than the value of the secured obligations at the relevant time). In the absence of a sound policy reason to do so, it would be inappropriate to impose a condition for the "provision" of collateral (i.e. that "excess" collateral only arises where its value exceeds the value of the secured obligations) that can be readily contracted out of by the parties. It makes more sense, from a policy perspective, to recognise that the parties to an RRA should retain the contractual autonomy to determine the level of collateralisation that is required and measure "excess" by reference to the value that the RRA so specifies.

[48] The definition of "relevant financial obligations" in regulation 3(1) refers to the *"obligations which are secured or covered by a financial collateral arrangement*"; and paragraph (c) of that definition expressly states that relevant financial obligations may *"consist of or include… obligations of a specified class or kind arising from time to time*". Paragraphs (a) to (c) of the definition set out an inclusive, non-exhaustive, list of the types of obligations that may constitute relevant financial obligations. If relevant financial obligations which are secured or covered by an RRA can comprise or include *"a specified class or kind of obligation"*, we consider it reasonable to conclude that the definition contemplates that: (1) it is a matter solely of contractual definition under the terms of the RRA to identify what obligations are, or are not, secured with respect to the totality of the obligations that are, or may come to be, owed to the collateral-taker; and (2) in much the same way as those terms may identify a class or kind of relevant financial obligations that do not include other classes or kinds of obligations that are, or may come to be, owed to the collateral-taker, they can equally define a quantum of obligations (less than the total amount of the obligations owed to the collateral-taker) as the "relevant financial obligations" under the RRA.

[49] As any under-collateralisation or over-collateralisation will be effected in accordance with the risk requirements of the collateral-taker, the operation of the supporting arrangements ensure a practical, useful and effective risk management procedure to reduce any risks that the collateral-taker has identified as arising out of or in connection with its dealings with the collateral-giver (or, if different, the debtor); and so the collateral-giver's related right to withdraw any excess collateral, which is not required under this procedure, is consistent with FCP1. Equally, the qualification of RRAs that adopt either an under-collateralisation or over-collateralisation mechanism as SFCAs, ensures that such RRAs operate consistently with FCP2 and FCP3 because SFCAs attract the legislative protections under the FCARs that promote the policy objectives at the foundations of those financial collateral principles.

RRA, there is no issue of transparency or concern of creditor detriment that would be offended by our preferred interpretation. Any such creditor or other third party cannot reasonably expect, consistent with FCP5, that the operational arrangements supporting the withdrawal of excess financial collateral should require the collateral-giver to maintain collateral under the relevant administrative control of the collateral-taker that has a value greater than the amount that it is required to post and maintain in accordance with its contractual obligation to the collateral-taker (as evidenced by the terms of the RRA itself). This is so even though the level of collateral so required by the RRA is less than the value of the secured obligations.

(3) Equally, there is nothing in the operation of an "over-collateralisation" RRA that is inconsistent with either FCP4 or FCP5. The possibility of such over-collateralisation should be understood by creditors (and other third parties) dealing with the collateral-giver as being a matter for the risk decision of the collateral-taker. If the collateral-taker determines, whether with regard to market, foreign exchange or other risk, that it requires to retain at all material times in its (or its agent's) relevant administrative control an amount of financial collateral that is, say, not less than 110% of the value of the secured obligations, then that is a matter that should be readily appreciated by third parties dealing with the collateral-giver (with reference to FCP4). The levels of collateralisation required by the collateral-taker will be readily discoverable by interested parties from the terms of the RRA itself. In addition, an "over-collateralisation" arrangement is not inconsistent with FCP5 because the collateral-taker has only agreed that collateral in excess of the relevant (say, 110%) threshold is not required by it to secure or cover the relevant financial obligations – and the RRA permits the collateral-giver to withdraw financial collateral beyond that threshold.

F. Other rights qualifying as "relevant rights"

Right to require return of collateral upon collateral-taker's insolvency

56. As we have outlined above, in order to mitigate against the risk of delay in the return of financial collateral under an RRA in the event of the collateral-taker's insolvency, it is increasingly common for collateral to be under the relevant administrative control of the collateral-taker (or a person acting on its behalf) while being retained in an account in the name of the collateral-giver (or a person acting on its behalf). In such a case, the RRA may contain terms to the effect that, if the collateral-taker becomes insolvent, the collateral-giver will be entitled to require the custodian to return the collateral to the collateral-giver.

57. If the right of the collateral-giver under the RRA is an unrestricted[50] right to require the release of the collateral upon the collateral-taker's insolvency, we consider that such a right as a relevant right would be inconsistent with the safety and risk considerations at the

[50] An "unrestricted right" for this purpose includes a right to require the release of the financial collateral upon the collateral-taker's insolvency subject solely to an assertion or (unverified) certification of the collateral-giver that it has discharged the relevant financial obligations secured or covered by the RRA.

foundation of FCP4. In particular, such an unrestricted right exercisable as a relevant right would cause the RRA to fail to operate with regard to the safety and interests of third parties dealing with the collateral-taker.

58. Creditors (and other third parties) dealing with the collateral-taker would reasonably expect the collateral-taker's exposure to the collateral-giver (or, if different, the debtor) to remain secured or covered (to the extent agreed under the RRA), until such time as the relevant financial obligations are discharged. The collateral-taker's claim on the collateral-giver (or, if different, the debtor) should remain a secured asset and, as such, be brought into the insolvency estate of the collateral-taker and be available for distribution to the body of unsecured creditors of the collateral-taker. To give an unrestricted right to the collateral-giver under an RRA to remove the collateral upon the insolvency of the collateral-taker would, or could potentially, change the nature of the asset owned by the collateral-taker – its secured claim would, to the prejudice of its creditors, be converted into an unsecured claim. In the event of a default by the collateral-giver (or, if different, the debtor) of its obligation to pay or otherwise discharge the relevant financial obligations, the insolvency estate of the (insolvent) collateral-taker would be reduced by the value of the financial collateral unilaterally withdrawn by the collateral-giver or, if that value is greater than the relevant financial obligations, the value of the relevant financial obligations (less, in either case, any sums paid by or ultimately recovered from the collateral-giver or, if different, the debtor).

59. As such a result would not reasonably be expected or discoverable by such third parties dealing with a collateral-taker by reason solely of the collateral-taker's relevant administrative control of the financial collateral, the exercise of the collateral-giver's unqualified right as a relevant right would, in our view, be inconsistent with FCP4.

A risk mitigation solution

60. However, if the collateral-giver's right to the return of the financial collateral upon the collateral-taker's insolvency were (upon the terms of the RRA) to be made conditional[51] upon its certification that it has paid or otherwise discharged the relevant financial obligations, we consider that the right should properly be characterised as a relevant right under the FCARs *if*:

(1) the collateral-giver assumes or otherwise accepts either:

(a) (where the certification depends upon a valuation that is to be carried out by the collateral-giver) a contractual or other legal obligation to the collateral-taker that it will carry out that valuation in good faith and in a commercially reasonable manner; or

[51] It would be necessary, of course, for the associated risk mitigation procedures described in this paragraph to operate both: (1) as a matter of contractual or other legal obligation on the part of the collateral-giver (or the person acting on its behalf) and contractual or other legal right for the collateral-taker (or the person acting on its behalf); and (2) in practice (i.e. the relevant contractual or other legal risk management measures must be complied with by all relevant parties at all material times).

(b) (where the certification depends upon a valuation that is to be carried out by a third party e.g. a custodian) a contractual or other legal obligation to procure that such third party will (and the third party must) undertake to the collateral-taker to carry out that valuation in good faith and in a commercially reasonable manner;

(2) (where the certification depends upon a valuation that is to be carried out by the collateral-giver or a third party) the person carrying out that valuation must have the technical expertise to do so;

(3) the collateral-giver is required to deliver its certification both to the collateral-taker and the relevant intermediary, CSD or account servicing institution that maintains the account to which the financial collateral is credited; and

(4) a reasonable time period is required to elapse between delivery of the certification to the collateral-taker and the relevant intermediary, CSD or account servicing institution and the time at which the collateral-giver is entitled to withdraw the collateral[52].

61. We consider that, if a collateral-giver's right to the return of financial collateral under an RRA in the event of the insolvency of the collateral-taker is qualified by the minimum risk mitigation measures we describe, it should be categorised as a "relevant right" for the purpose of the FCARs and should not prevent the provision of the relevant financial collateral to the collateral-taker (or a person acting on its behalf) under the FCARs. The right, as operating within the suggested risk mitigation framework, is consistent with:

(1) FCP1 – as it supports a practical, useful and effective operational arrangement that allows a collateral-giver to manage the risks arising for it upon the insolvency of the collateral-taker (by maintaining the financial collateral in an account in its own name or another person acting on its behalf);

(2) FCP2 and FCP3 – as it would enable the collateral-taker (notwithstanding its insolvency) to benefit from the relevant protections afforded to SFCAs under the FCARs that limit the administrative burdens for collateral-takers and support the rapid and non-formalistic enforcement of a security interest under an RRA with a view to safeguarding financial stability and limiting contagion effects upon the occurrence of an enforcement event[53];

[52] The intention here is that the time period should be of sufficient length to enable the collateral-taker under the RRA (or its insolvency office-holder) a reasonable time: first, to evaluate the validity of the certification (and any related valuation); and, second, to seek injunctive or other equitable relief if it wishes to challenge the certification on the basis that it was made fraudulently, in breach of contract or in breach of any other duty owed by the collateral-giver (or any third party making a relevant valuation) to the collateral-taker.

[53] In addition, consistent with FCP2, it avoids the administrative burden for the collateral-taker of having to arrange for relevant financial collateral to be credited to an account maintained by it with a custodian.

(3) FCP4 – as the risk management framework, by minimising risk (including the risk of fraud), ensures that the practical operation of the RRA achieves a balance between market efficiency and the safety of the parties to the RRA and other affected third parties; and

(4) FCP5 – as the practical operation of the arrangement ensures that financial collateral will be promptly returned to the collateral-giver once, for all intents and purposes, the parties are agreed that the relevant financial obligations are fully discharged and, therefore, the collateral is no longer required as security or cover for the relevant financial obligations[54].

[54] We also consider there to be an alternative analysis that supports our conclusion that the right to the return of collateral upon the collateral-taker's insolvency, subject to the risk mitigation framework we describe above, should not prevent the provision of the financial collateral to the collateral-taker under the RRA. As we have explained in paragraph [14(1)] of this Guidance, a right reserved by, or granted to, a collateral-giver in relation to financial collateral, that is in the relevant administrative control of the collateral-taker, may only prevent the provision of the collateral if it is exercisable in relation to collateral that is at the relevant time securing or covering relevant financial obligations under the RRA. The risk mitigation framework we have proposed means that, as a practical matter, the right to the return of the collateral is at all times conditional upon, and is only exercisable after, the full discharge of the relevant financial obligations.