Feature

KEY POINTS
- To qualify as a security financial collateral arrangement it is necessary for a collateral-taker to have possession or control of financial collateral.
- A frequently encountered type of security financial collateral arrangement takes a form which often requires analysis of "control" and "excess" under English law.
- Under English law, it is not certain what "control" means in this context.
- General risk management practices and regulatory provisions suggest certain security financial collateral arrangements should contain features which are challenging to the analysis of "control".
- This creates undesirable legal uncertainty under English law.

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Financial collateral arrangements in the age of uncleared margin

This article considers uncertainties that beset the creation of market standard security financial collateral arrangements against the backdrop of the requirements flowing from Art 11 of Reg 648/2012.

BACKGROUND

The importance of financial collateral arrangements has recently been highlighted by Art 11 of EU Reg 648/2012 (EMIR) and the related final draft regulatory technical standards published by ESMA on 8 March 2016 (Draft RTS), which contain requirements both to segregate collateral representing initial margin for non-centrally cleared derivatives and to make it available to the collateral-provider in a timely manner upon the default of the collateral-taker, neither of which are easily reconcilable with the English law related to financial collateral. The requirements under the Draft RTS will apply in stages between: (i) 1 September 2016, when market participants, that have an aggregate monthly notional amount of such derivatives exceeding €3trn; and (ii) 1 September 2020, when any counterparty belonging to a group whose aggregate month-end average notional amount of such derivatives exceeds €8bn; in each case, become subject to the requirements.

As a general matter, the provision of financial collateral underpins a vast number of financial transactions. The EU Directive on Financial Collateral Arrangements (Directive 2002/47/EC, (Directive)) was introduced to harmonise national regimes for the provision of securities and cash as collateral, and to simplify the process of taking and enforcing security over such assets by removing certain formalities applicable to security interests over financial collateral and disapplying certain insolvency law provisions with respect to financial collateral arrangements. The Directive applies to financial collateral in the form of cash, securities and credit claims. The Financial Collateral Arrangements (No 2) Regulations 2003 (SI 2003/3226, (Regulations)) implement the Directive in the UK. In the UK, the key changes to law (amongst others) made by the Regulations were:

- the removal of the requirement to register charges (in respect of financial collateral);
- the disapplication of the moratorium on enforcement of security that would otherwise arise when a collateral-provider enters administration proceedings; and
- (once introduced by SI 2010/2993) the requirement under reg 15A for courts not to give effect to the orders of foreign courts, in relation to relevant insolvency law, which would conflict with the Regulations.

Under the Regulations (reg 3(1)), security financial collateral arrangements are agreements (between non-natural persons and evidenced in writing) under which a security interest is created over financial collateral to secure "relevant financial obligations" owed to the collateral-taker, and:

> 'the financial collateral is … in the possession or under the control of the collateral-taker or a person acting on its behalf; any right of the collateral-provider to substitute … or withdraw excess financial collateral … shall not prevent the financial collateral being in the possession or under the control of the collateral-taker.'

Since the implementation of the Regulations, a great deal has happened in the financial markets which enhances the importance of having a practical and useable financial collateral regime. Article 11 of EMIR imposed a requirement for uncleared derivatives to be collateralised with the intention to reduce the impact of future financial crises. Article 33(2) of the Draft RTS, in relation to initial margin, requires that:

> (a) where collateral is a proprietary asset of the collecting counterparty, it shall be segregated from the other proprietary assets of the collecting counterparty;
> (b) where collateral is a not proprietary asset of the collecting counterparty, it shall be segregated from the proprietary assets of the posting counterparty;
> (c) it shall be segregated from the proprietary assets of the third-party holder or custodian.'

Further, Art 33(4) specifies that:

> 'The segregation arrangements shall ensure that collateral posted as initial margins are available to the posting counterparty in a timely manner in case the collecting counterparty defaults.'

Additionally, there are requirements pursuant to Art 194 of the Capital Requirements Regulation (575/2013) (CRR) which sets out prudential requirements for credit institutions and investment firms for institutions to obtain a legal opinion addressing the efficacy of credit risk mitigation techniques, which can be challenging to meet in the context of an English law security financial collateral arrangement.

There are significant and undesirable tensions between applying the requirements of the Regulations, the Draft RTS and CRR to a security financial collateral arrangement in the form of an English law fixed or floating charge.

A FREQUENTLY ENCOUNTERED SCENARIO

It has become more frequent since the financial crisis for collateral arrangements related to initial margin to be structured such that financial collateral is held in a third party account in the name of the collateral-provider. This kind of structure may involve the holding of financial collateral in the collateral-provider's account and a triparty agreement between the collateral-provider, the collateral-taker and a custodian to document the arrangements. The collateral-provider grants a security interest over the account to secure its obligations to the collateral-taker. In these circumstances the question is whether the collateral-taker has "control" of the collateral such that the protections applicable to a security financial collateral arrangement apply.

In such arrangements, although the financial collateral might be held in the collateral-provider's account its rights in respect of the financial collateral are limited. The collateral-provider is often given the rights to substitute financial collateral of the same or greater value or to withdraw excess financial collateral. But beyond those rights the custodian will agree not to permit the collateral-provider to remove any financial collateral while the secured obligations are outstanding (except as otherwise agreed). Further, if the collateral-taker notifies the custodian that the security has become enforceable, the custodian will be required to follow the collateral-taker's instructions.

ISSUES OF "CONTROL" AND "EXCESS"

In light of the frequently encountered example presented above, this article is focused on uncertainties related to the definition of "control" and "excess financial collateral". Under English law, "control" is often interpreted in line with an analysis of legal control for fixed to floating charge recharacterisation purposes, where the leading authorities such as *Re Spectrum Plus* [2005] 2 AC 680 (*Spectrum Plus*) are relatively restrictive. In *Spectrum Plus*, the collateral-provider was free to deal with a cash account forming part of the collateral in the ordinary course of business. But *Spectrum Plus* was concerned (amongst other things) with whether the relevant charge was fixed or floating, not with whether it amounted to a security financial collateral arrangement.

While there are a variety of features, whether amounting to day to day management of the collateral, or rights that arise upon the default of the collateral-taker, that might cause some uncertainty around the control analysis (such as entitlements for the collateral-provider to receive copies of notices, exercise voting rights or receive or withdraw income, in respect of relevant financial collateral) the key issues of debate that crop up time and again are any right of the collateral-provider to withdraw collateral upon the default of the collateral-taker and any ability of the collateral-provider to determine any excess which is repayable to the collateral-provider. Key subsets of these issues revolve around which defaults might trigger a right to withdraw collateral, because some defaults are objectively verifiable, some are not, and the extent to which the protections applied to the withdrawal of excess present issues which are damaging to the control analysis.

One approach to the right of withdrawal is to say it simply is not required in an English law arrangement because the collateral-provider can rely upon its proprietary rights to require redemption and discharge of the security interest (as examined in *Kreglinger v New Patagonia Meat and Cold Storage Company Limited* [1914] AC 25). While that is legally accurate it can sometimes ignore the fetters on the exercise of those rights as a result of the application of insolvency law (such as a moratoria applicable to a collateral-taker or custodian as a result of a collateral-taker's/custodian's administration pursuant to the UK Insolvency Act 1986). For entirely understandable reasons, for example to protect their own liquidity, parties sometimes seek practical, contractual protection. The extent of any such protection ought to be a matter of commercial negotiation and risk allocation between the parties, but the nature of the law makes this difficult to achieve in practice. In any event, the Draft RTS makes it clear that there is a regulatory expectation that a mechanism will exist to allow for timely withdrawal of collateral from arrangements which fall within its ambit.

Gray v G-T-P Group Limited [2011] 1 BCLC 313 (*Gray*) made it clear that "negative control" is sufficient for the Regulations to apply. Notwithstanding this, it is unclear what amounts to "negative control" and whether the above features (amongst others) would be damaging to an analysis of "control" under the Regulations. Even where directly contemplated by the Directive and the Regulations, the rights a collateral-provider has in relation to collateral, whether day to day or in the event of a default by the collateral-taker, have a direct impact on the efficacy of the rights a collateral-taker has to enforce against the collateral in the event of a collateral-provider's default. This creates undesirable legal uncertainty and seems inconsistent both with the Directive, EMIR and the Draft RTS. Further, it means that firms subject to the requirements of CRR may (depending on the features contained in such an arrangement) struggle to obtain the requisite legal comfort, potentially making the arrangement uneconomic or burdensome for such a firm.

Despite providing that if the collateral-provider has any rights to withdraw excess financial collateral it will not prevent the financial collateral being in the possession or under the control of the collateral-taker, the Regulations do not define the meaning of "excess financial collateral". Notwithstanding this uncertainty, it seems reasonably safe to assume "excess" would encompass a value in excess of the value of the relevant secured obligations. However, in the scenario outlined above, this is problematic because if the party determining the value of the "excess" is the collateral-provider (which of course it would be in the event of a collateral-taker default) it raises the concern that the determination might not be objective. Regardless, it would seem to defeat the purposes of the Directive and the Draft RTS, if in analysing the character of an individual

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collateral arrangement, there is always an assumption (without regard to the terms of such arrangement) that such a determination could not (or might not) be objective. In other relevant ways the collateral is clearly segregated from the proprietary assets of the collateral-provider and under the control of the collateral-taker.

If it was considered desirable, the challenges outlined above to a traditional analysis of "control" could be addressed by: (i) the collateral-provider certifying that the secured obligations have been discharged to the collateral-taker as well as the custodian with which the account is held; (ii) the collateral-provider being required to act reasonably and in good faith in carrying out any valuations; and (iii) the rights to withdraw excess financial collateral from the account only arising after a designated period has elapsed, such that the collateral-taker will have sufficient time to seek an injunction if the certification has been provided fraudulently, or been subject to dispute. On this basis it ought to be possible to say that "control" exists. It is not currently possible to do so with certainty. A possible response to this from the draftsperson of the Regulations is that it would be free for the parties to agree a greater role for the custodian in verification of the determination of value. This is true, but: (i) as a party not accustomed to taking legal risk, a custodian will be reluctant to assume such a role, leaving the parties with no easy mechanism to establish control; and (ii) this does not sit easily with the requirement for segregation from the estate of the custodian pursuant to the Draft RTS.

One response that might be made to the arguments made in this article, in particular that a role exists for the collateral-provider in determining excess, is that the directive is focused on the reduction of fraud risk (extract from recital 10 of the Directive):

> 'This Directive must however provide a balance between market efficiency and the safety of the parties to the arrangement and third parties, thereby avoiding inter alia the risk of fraud. This balance should be achieved through the scope of this Directive covering only those financial collateral arrangements which provide for some form of dispossession ...'

Nonetheless, it is important to note the qualifying language of "some form of dispossession". It does not seem inconsistent with this concept that the parties to a collateral arrangement agree a mechanism with a role for the collateral-provider in determination of "excess" when it includes requirements for objectivity and other protections. It would seem to fly in the face of commercial logic that the party that is in those circumstances contemplated to be in default, the collateral-taker, should make a determination, or be required to consent to the consequences of such a determination, when industry documentation would provide for the collateral-provider to make such a determination by virtue of it being the collateral-taker that has defaulted.

If the collateral-provider has a right that *might be* interpreted as being unrestricted to require the release of the financial collateral from the collateral arrangements if the collateral-taker becomes insolvent, there is a risk the collateral-taker does not have sufficient "control" to establish the arrangement as a security financial collateral arrangement under English law. If the collateral-taker would otherwise have "control" of the financial collateral, the collateral-provider having rights to require release of such part of the collateral that is "excess" following discharge of the secured obligations should not challenge the efficacy of the arrangement.

SOLUTIONS

Ultimately, to facilitate desirable legal certainty in this regard, either a change in interpretation of the law is required, or a change in the law itself. It would be of considerable benefit to legal certainty if the Regulations were amended to clarify that a right to withdraw excess is not inconsistent with control if the secured obligations have been certified as being discharged and that a determination of the excess made by the collateral-provider is valid if it is performed reasonably, in good faith or otherwise in accordance with the procedure agreed between the parties for such determination. This could be accomplished by making the following amendments to the Regulations:

- Inserting a non-exhaustive definition of "control of the collateral-taker" in the following terms 'includes the case whereby provisions have been included in the security financial collateral arrangement to provide for timely release of excess financial collateral to the collateral-provider in the event of the default of the collateral-taker, provided that the arrangement includes a mechanism to allow for a contractual challenge by the collateral-taker to the withdrawal of excess financial collateral where the terms of the arrangement would not permit it or the elapse of a designated period prior to the actual release of excess financial collateral to the collateral-provider; ...' if it were felt desirable, this provision could also be extended to cover other typical control rights that do not threaten the analysis of "negative control".
- Inserting a definition of "excess financial collateral" in the following terms 'includes the case where the value of the financial collateral to which a financial collateral arrangement relates exceeds an amount agreed between the parties, or determined by reference to a formula or any other criteria agreed between the parties, including, but not limited, to any agreement between the parties that any such determination is made by the collateral-taker, the collateral-provider or a third party, reasonably or in good faith or as otherwise provided by the terms of the relevant agreement(s) between the parties'.
- Amending the definition of "security financial collateral arrangement" and "security interest" to include the words *"(including upon the default of the collateral-taker)"* after the words "withdraw excess financial collateral". ■

Further Reading:

- Use of a portfolio of securities held by a custodian to provide financial collateral [2016] 3 JIBFL 134.
- The proposal for segregated exchange of initial margin: are OTC derivatives markets safer? [2014] 10 JIBFL 639.
- LexisPSL: JIBFL article: When clearing members go bust: OTC clearing and the protection of initial margin under EMIR.