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Financial Collateral Arrangements and "possession": shades of Gray

Last year, doubt was cast on the ability of a collateral-taker to establish a security financial collateral arrangement over intangible property by taking "possession" of that property and thereby benefit from the many protections afforded by the Financial Collateral Arrangements (No. 2) Regulations 2003 (the Regulations that implement the Financial Collateral Directive in the UK). In *Gray v G-T-P Group Ltd,* the judge, to the surprise of many, suggested that possession of intangible property is a difficult concept and focused instead on control, the alternative method of creating a security financial collateral arrangement. From 6 April 2011, however, the 2003 Regulations will include a shiny new provision relating to "possession". This provision clarifies that possession of intangible property, like dematerialised securities, is possible for the purposes of creating a security financial collateral arrangement, albeit subject to some significant restrictions. Unfortunately, there is as yet no clarification on what is meant by "control" in the 2003 Regulations.

On 6 April 2011, the Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations 2010, which were made by the Treasury on 15 December 2010, come into force. The 2010 Regulations amend certain provisions of the 2003 Regulations and certain provisions of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999. The majority of the amendments being made are to provide for settlement finality between linked or "interoperable" systems, and to include credit claims as financial collateral (the UK implementation of recent amendments to the Financial Collateral Directive, and the focus of a Treasury consultation paper released in August 2010). There are, however, additional amendments to the 2003 Regulations.

The new "possession" provision

The Treasury received a number of industry responses to its August 2010 consultation. Those responses highlighted concerns about the uncertainty surrounding the application of the 2003 Regulations to arrangements where collateral is taken by way of security over intangible property; uncertainty which had been exacerbated by the decision in *Gray v G-T-P Group Ltd (Re F2G Realisations Ltd)* [2010] EWHC 1772 (Ch). For an arrangement to be a security financial collateral arrangement under the 2003 Regulations, the collateral must be "in the possession or under the control" of the collateral-taker. The decision in *Gray* effectively ruled out possession as a means of creating a security financial collateral arrangement over intangible property, and suggests that a floating charge would not satisfy the requirement for control, notwithstanding that floating charges are expressly referenced in the 2003 Regulations. This shocked many in the industry. First, while it had never been clear exactly what constituted "control" under the 2003 Regulations, many thought that this test could not be the same as the control test used by the English courts to characterise a charge as fixed rather than floating. Second, here in the 21st Century, most collateral taken by or provided to financial institutions is in the form of intangible property. Prior to *Gray*, it was widely thought that possession, for the purposes of the 2003 Regulations, had a common sense, practical meaning, capable of applying to intangible property – not an old English law one.

Key Issues

- **For an arrangement to be a security financial collateral arrangement under the 2003 Regulations, the collateral must be "in the possession or under the control" of the collateral-taker.**
- **The judgment in *Gray* suggested that (a) possession of intangible property is a difficult concept and (b) a floating charge would not satisfy the requirement for control, notwithstanding that floating charges are expressly referenced in the 2003 Regulations.**
- **No new developments on the "control" point.**
- **"Possession"? From 6 April 2011, the 2003 Regulations will include a new provision relating to "possession".**
- **The provision has some significant restrictions which should be borne in mind when structuring collateral arrangements.**

If you would like to know more about the subjects covered in this publication or our services, please contact:

Chris Bates +44 (0)20 7006 1041

Kate Gibbons +44 (0)20 7006 2544

Simon Gleeson +44 (0)20 7006 4979

John MacLennan +44 (0)20 7006 1642

Habib Motani +44 (0)20 7006 1718

Dermot Turing +44 (0)20 7006 1630

Jeremy Walter +44 (0) 20 7006 8892

Caroline Meinertz +44 (0)20 7006 4253

Emma Chell +44 (0)20 7006 2954

To email one of the above, please use firstname.lastname@cliffordchance.com

Clifford Chance LLP, 10 Upper Bank Street, London, E14 5JJ, UK
www.cliffordchance.com

So where are we now? Unfortunately, no clarity has been provided on the control issue but the Treasury has, in the 2010 Regulations, sought to address the possession issue.

The following provision is being added to the 2003 Regulations:

> "For the purposes of these Regulations "possession" of financial collateral in the form of cash or financial instruments 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 person acting on his behalf, has credited the financial collateral to an account in the name of the collateral-provider 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 to withdraw excess financial collateral."

There will still be no exhaustive definition of "possession" in the 2003 Regulations – rather, this new provision clarifies, within the broader meaning of possession, that an arrangement of the type specified should be treated as amounting to possession under the 2003 Regulations. In respect of such an arrangement, possession of intangible property, like dematerialised securities, will be possible for the purposes of creating a security financial collateral arrangement, albeit subject to some significant restrictions. Entities seeking to rely on this newly inserted provision will need to pay attention to its precise terms when structuring their collateral arrangements.

Implications of the proviso?

The implications of the proviso contained within the new possession provision will certainly require further thought. The proviso muddies the water by importing certain ideas more usually associated with the tests for control into the test for possession; it means that a collateral-taker will only have "possession" of the financial collateral if the collateral-provider's rights are limited to the right to substitute or to withdraw excess financial collateral. This could be problematic for some collateral arrangements. In the custody sphere, for example, the extension of credit which is collateralised by a lien or charge is incidental to the custody services being provided. Custody clients typically have the right to withdraw from their custody accounts freely, subject to the custodian's ability to set off amounts owed to it. Can a custodian in those circumstances be said to have "possession" of the financial collateral under this new provision? A difficult question. Undoubtedly, these issues, and the meaning of control, are in need of legislative clarification. In the meantime, it is hoped that they can be structured around.

Other amendments to the 2003 Regulations

It is worth noting that the 2010 Regulations will make some other helpful amendments to the 2003 Regulations, including adding certain (previously omitted) items to the list of insolvency legislation provisions which are disapplied in relation to financial collateral arrangements. Notably:

- sections 40 and 175 of the Insolvency Act 1986 (preferential debts) will not apply to any debt which is secured by a charge created or otherwise arising under a financial collateral arrangement;
- paragraphs 99(3) and (4) of Schedule B1 to the Insolvency Act 1986 and sections 19(4) and 19(5) of the Insolvency Act 1986 (administrator's remuneration, expenses and liabilities) (which, broadly, provide that administration expenses rank ahead of floating charge holders) will not apply to any security interest created or otherwise arising under a financial collateral arrangement; and
- section 176ZA of the Insolvency Act 1986 (expenses of winding up) will not apply in relation to any claim to any property which is subject to a disposition or created or otherwise arising under a financial collateral arrangement.

Conclusions

When the 2010 Regulations come into force on 6 April 2011, we will have legislative clarity that, for the purposes of the 2003 Regulations, "possession" does have meaning in respect of intangible property – and in a post-*Gray* world, this is, of course, welcome. However, the new provision is not without difficulty: careful thought will need to be given to its precise terms when structuring collateral arrangements that seek to fall within it.

Previous Clifford Chance publications on this topic:

Transaction Services Newsletter, October 2010

Clifford Chance briefing, July 2010