

**International Swaps and Derivatives Association, Inc.**  
COLLATERAL LAW REFORM GROUP

# **UNITED KINGDOM**

## **COUNTRY REPORT**

Supplement to  
*Collateral Arrangements in the European Financial Markets:  
The Need for National Law Reform*

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***UNITED KINGDOM***  
***(England and Wales)***

NOTE: This report deals only with the position in England and Wales, which form a single legal jurisdiction within the United Kingdom. The other jurisdictions within the United Kingdom are Scotland and Northern Ireland. For ease of reference, this summary generally refers only to England.

*Summary report on the legal framework for collateral arrangements for financial activity*

Summary of the legal analysis under the laws of England applicable to collateral arrangements intended to secure financial trading activity in relation to privately negotiated derivative transactions, securities trading, securities repurchase transactions, stock lending and similar financial transactions in the wholesale financial markets. It is assumed that at least one of the parties involved is a financial institution (credit institution or investment firm) and that the collateral involved is cash, in euros or some other freely available currency, and/or fungible securities listed on a stock exchange or recognised market and held in immobilised or dematerialised form in a clearing system (“Fungible Securities”). References to “collateral” below indicate cash and Fungible Securities, unless otherwise specified.

*This summary was prepared for the purpose of identifying possible areas of uncertainty or commercial impracticality arising under the laws of England in relation to collateral arrangements. It is not intended to be a definitive summary of the legal position relating to collateral in England and should not be relied on as such.*

*The position is stated as of December 1999.*

*This summary, prepared by the Collateral Law Reform Group, does not necessarily represent the views of ISDA or any of its members. It is a subjective assessment of the position in England and is simply intended to encourage debate and discussion of the relevant issues.*

**KEY POINTS FOR CONSIDERATION FOR ENGLAND**

- (1) The owner of a share in a pool of Fungible Securities would have absolute title to and/or an indirect interest in the assets.
- (2) The *lex loci* of Fungible Securities held through an account in a clearing system is the place where the account is held.
- (3) Conflicts of law rules would apply the *lex loci* to a holding or the transfer of Fungible Securities and the perfection of a security interest in Fungible Securities and the governing law of any agreement in relation to possession of Fungible Securities and creation of a security interest.

- (4) A security interest may require to be officially registered with certain state agencies.
- (5) A pledge may not use pledged assets as its own property without the other party's consent. It is not clear what the position is with consent.
- (6) No formal procedures apply to enforcement of a security interest.
- (7) Enforcement of a security interest may not be delayed and is not stayed on insolvency.
- (8) Title transfer arrangements will not be recharacterised.
- (9) Close-out netting under an ISDA Master Agreement is enforceable.
- (10) Contractual set-off is enforceable on insolvency.
- (11) Third party claims will not disrupt set-off and netting between solvent counterparties.
- (12) Top-up collateral will not be avoided as a preference.

**1. Do the laws of England deal clearly with the nature of a participant's interest in a holding of Fungible Securities?**

There is no statutory provision determining the nature of a participant's interest. This would therefore be determined by reference to general principles of property and trust law and the terms of participation in the relevant clearing system.

**2. How would such an interest be characterised under those laws?**

Though there is no direct authority on the point, it is generally considered that such an interest would be characterised as a co-proprietorship interest in the underlying pool of securities of the relevant description held by or on behalf of the clearing system.

**3. How would the location of the Fungible Securities be determined under the laws of England?**

We take this question to refer to the location of the "Fungible Securities" held by the participant to whose account securities are credited in the clearing system - that is the co-proprietorship interest held by the participant as mentioned in the answer to Question 2. It is generally considered that this interest is located where the clearing system is operated.

**4. Under English conflict of law rules, what law would govern:**

**(a) the characterisation of a person's holding of Fungible Securities?**

Taking "holding of Fungible Securities" in the sense explained in the answer to Question 3 above, an English court would in our view look to the law governing the relationship between the clearing system and the participant as determining the nature of the rights of the participant with respect to its holding.

**(b) the creation of a security interest in cash or Fungible Securities?**

The construction and contractual effect of an instrument creating a security interest would be governed by the proper law of the instrument, determined in accordance with the Rome Convention, where applicable, and by the relevant principles of the common law in other cases. The proprietary effects of such an instrument would be governed by the law of the jurisdiction in which the cash or Fungible Securities were regarded as situated for purposes of English law. For the situation in relation to Fungible Securities, see the answer to Question 3 above. Cash in the form of a deposit in a bank account (which we presume to be what is contemplated here) is regarded as situated where the branch or office at which the account is maintained is situated.

**(c) the formal validity or perfection of a security interest in cash or Fungible Securities?**

In relation to a cash deposit, these matters would be governed by the law governing the deposit. In relation to Fungible Securities, they would be governed by the law of the jurisdiction in which the Fungible Securities were regarded as situated.

**(d) the effectiveness or formal validity of a transfer of title to Fungible Securities?**

In relation to a cash deposit, these matters would be governed by the law governing the deposit. In relation to Fungible Securities, they would be governed by the law of the jurisdiction in which the Fungible Securities were regarded as situated.

**5. What types of security interest may be created under the laws of England in:****(a) cash?****(b) Fungible Securities?**

**Where more than one type of security interest is possible, please indicate which type(s) would typically be used for collateral arrangements involving cash and/or Fungible Securities, and why.**

Cash in the form of a credit balance in a bank or other account may be the subject of a legal mortgage or of an equitable mortgage or charge.<sup>1</sup> A legal mortgage involves the assignment of the deposit into the name of the lender, with provision for reassignment on discharge of the secured obligations. An equitable mortgage is similar, except that it involves the assignment only of the beneficial interest in the deposit, the account remaining in the name of the mortgagor. An equitable charge does not involve an assignment of the title to the deposit, but an appropriation of the chargor's rights under the deposit towards the discharge of the secured obligations. This will normally be coupled with express powers of sale and realisation.

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Where the bank with which the account is held is also the person taking security, only an equitable charge may be used. In practice, the charge would normally be combined with a right to set off the obligation to repay the deposit against the secured obligation and a "flawed asset" arrangement making repayment of the deposit conditional on the discharge of the secured obligation.

The participant's interest in Fungible Securities<sup>2</sup> may in principle be the subject of the three types of security interest described in (a) above.

- 6. In relation to each of these types of security interest, describe briefly any filing, registration, notification, notarisation or other formal requirements necessary to ensure validity of (or "perfect") the security interest. In relation to each type of security interest, please indicate the consequence of failing to comply with the relevant requirement.**

Where the person granting a charge<sup>3</sup> is a company registered in England, it may be required to deliver the instrument creating the charge, together with prescribed particulars of the terms of the charge, to the Registrar of Companies within 21 days from the creation of the charge. Whether this requirement applies depends partly on the terms of the charge<sup>4</sup> and partly on the nature of the charged property.<sup>5</sup> Where a charge is registered, details of it are recorded on a register which is open to public inspection.

Failure to comply with these requirements constitutes a criminal offence on the part of the company creating the security. In addition it renders the charge void against any liquidator, administrator or other creditor of the company.

These requirements apply to all the three types of security described above.

Similar registration requirements apply to charges over property in England and Wales created by a company incorporated outside Great Britain which has an established place of business in England and Wales.

- 7. In relation to each type of security interest, indicate whether the collateral receiver is entitled to use the collateral as though it were the absolute owner of the collateral, including the right to sell, lend or re-pledge (rehypothecate) the collateral to a third party.**

In the absence of express authority conferred by the giver of the collateral, the collateral receiver is not entitled to use the collateral as though it were the absolute owner.

There is no statutory provision or case law dealing specifically with the position where such an express authority is conferred, and there is some difference of view among practitioners on whether such an authority is effective to enable the collateral receiver to use the collateral as though it were the absolute owner.

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<sup>2</sup> The property of the participant which is capable of being the subject of a security interest will be its co-proprietorship interest in the pool of underlying securities, rather than any particular underlying securities. This tends to be obscured by the terminology generally used - it would be common to speak of a participant granting security over "its bonds/shares held at [the clearing system]".

<sup>3</sup> For this purpose "charge" includes a mortgage.

<sup>4</sup> A floating charge is required to be registered whatever the nature of the property to which it applies. A charge which is stated to be a fixed or specific charge may nevertheless be regarded as a floating charge if it has the characteristics of such a charge. Broadly, a charge will be regarded as a floating charge if it applies to a fluctuating class of present and future property and the chargor is able to deal with the charged property free from the charge until a specified event occurs or the chargee intervenes.

<sup>5</sup> Charges required to be registered include charges on book debts of a company. There is no statutory definition of what constitutes a "book debt" for this purpose; the term is generally taken to refer to a debt which would be entered in properly maintained books of account as a debt (for example, a receivable). Charges over securities or interests in securities are sometimes registered for fear that, to the extent that they extend to interest and other payments on the securities, they may amount to charges on future book debts. The same considerations govern whether a charge on a cash deposit is required to be registered; such a deposit is clearly a debt, but it may be recorded as "cash at bank" rather than as a receivable or other debt.

- 8. Briefly describe the enforcement procedures for each type of security interest commonly used for collateral in relation to financial activity. For example, is court approval required before the security interest may be enforced and/or is some form of auction procedure required. Indicate any practical difficulties typically encountered and also the relative efficiency and speed (or lack of same) of such procedures. Comment in particular on the possibility of a stay or freeze in the event that the collateral provider is subject to formal insolvency proceedings of any type.**

The procedure most commonly used, in relation to all three types of security interest referred to in the answer to Question 5, is a sale by the collateral holder in the exercise of a power of sale conferred by the mortgage or charge document. A properly drawn document will include a security power of attorney which will enable the collateral holder to execute instruments of transfer and other necessary documents on behalf of the giver of collateral.

Except where an administration petition is pending or an administrator has been appointed, there is no requirement for court approval. No form of auction procedure is required.

The holder of a legal or equitable mortgage may also apply to the court for a foreclosure order vesting full ownership of the collateral in him. This procedure involves a court hearing. It has no particular advantage over the exercise of a power of sale and is rarely used.

- 9.a. In relation to local law collateral arrangements based on transfer of title, please indicate whether there is a risk that the courts of England would recharacterise the transfer of title as the creation of a form of security interest. If so, give some indication of the degree of risk. Please indicate the consequences of such a recharacterisation.**

In principle, there is a risk that an English court would characterise a disposition which purported to be made by way of outright transfer as the creation of a form of security interest. It would however do so only if it concluded that the true nature of the arrangement between the parties was inconsistent with the characterisation which they had applied to it. The courts would approach this question primarily by reference to the terms of the documentation. If therefore the documentation were clear, consistent and unambiguous, and there were no indication from other evidence or from the parties' behaviour that the documentation did not reflect their true understanding, the risk of recharacterisation can be regarded as very low.

If a disposition purportedly made by way of outright transfer were recharacterised as the creation of a form of security interest, it might as a result be held to be subject to the registration requirements referred to in the answer to Question 6 above, and might be held to be void as a result.

- 9.b. If the agreement is governed by a foreign system of law that does not recharacterise, would the risk of recharacterisation under domestic law still be present?**

The position would be the same as that outlined in the answer to Question 9.a. above.

- 10. Is close-out netting, for example under a 1992 ISDA Master Agreement, enforceable under the laws of England? If so, but subject to certain limitations (for example, as to the nature of the counterparty or types of transaction included within the netting), please indicate briefly what those limitations are.**

Close-out netting is enforceable under English law provided that it does not conflict with the mandatory rules of English insolvency law relating to the set-off of outstanding obligations in

a liquidation. The principal respects in which these rules could limit the enforceability of close-out netting are -

- (a) only obligations which are mutual can be included in the netting;
- (b) obligations incurred at a time after the person seeking to close out has notice that a winding-up petition had been presented against the counterparty cannot be included in the netting;
- (c) to the extent that the claims included in the netting include foreign currency items, they may be converted into sterling at the rates laid down by the insolvency rules and not by those specified in the contract, if different.

See also the netting opinions provided to ISDA by Allen & Overy of March 1998 and November 1998.

- 11. Is contractual set-off and/or insolvency set-off enforceable in the event of formal insolvency proceedings in the courts of England in relation to a counterparty organised in England? Please indicate the answer in relation to each type of formal insolvency proceeding (including rehabilitation or reorganisation proceedings such as administration or *redressement judiciaire*) possible in that country in relation to a corporate entity (including a financial institution). Comment in particular on the possibility of a stay or freeze in the event that the collateral provider is subject to formal insolvency proceedings of any type.**

In proceedings for the winding up of a company or bankruptcy of an individual, insolvency set-off of all mutual debts in accordance with the applicable insolvency rules is mandatory. Insolvency set-off overrides any conflicting contractual set-off (see the answer to Question 10 above).

Mandatory insolvency set-off does not apply in the context of other insolvency proceedings such as administration or voluntary arrangement. Contractual set-off will be enforceable in the event of such proceedings.

- 12. Would the exercise of netting or set off rights under a title transfer collateral arrangement be vulnerable to the rights of third parties in the event of the insolvency of the collateral giver? For example, would it be possible for the collateral giver to disrupt (deliberately or inadvertently) the netting or set-off by assigning to a third party creditor its right to redelivery of equivalent collateral under the collateral arrangement? Could that right to redelivery be attached by a third party creditor of the collateral giver free of the collateral taker's netting or set off rights under the collateral arrangement?**

Provided that (a) the title transfer collateral arrangement and (b) the contract(s) giving rise to the claims supported by the title transfer collateral arrangement have been entered into before the collateral taker has notice of the claim of the third party creditor, then the collateral taker has priority in the exercise of its netting and/or set-off right against the value of the collateral under the collateral arrangement. In other words, in such circumstances the third party creditor's interest is subject to the collateral taker's right to net and/or set off.

- 13. In relation to mark-to-market collateral arrangements, is there any risk under the preference (or similar) rules of England that "top-up" deliveries of collateral would be**

**vulnerable to avoidance if made during a relevant period prior to the insolvency of the collateral giver?**

In principle, a disposition of property made within a specified period (generally six months) prior to the onset of insolvency may be set aside as a preference if its is made in favour of a creditor and has the effect of putting the creditor in a better position in the insolvency than that in which it would have been but for the disposition. This is, however, subject to a number of qualifications, one of which is that a disposition will not be set aside unless the person making it was “influenced by a desire” to place the creditor in a better position. If, as could generally be expected to be the case, the principal motivation for a transfer of “top-up” collateral is to comply with a pre-existing contractual obligation and thereby avoid the possible sanctions for breach (in particular, the application of default and close-out provisions against the party in breach), the transferor is unlikely to be regarded as influenced by a desire to place the creditor in a better position and the transfer will not therefore be vulnerable as a preference.

- 14. Please add any additional comments on the general legal framework for collateral arrangements under the laws of England, whether based on creation of a security interest or on title transfer, highlighting any difficulties that should be addressed in any project for collateral law reform in England.**

Some improvements to registration of charges regime to clarify when charges are registrable would be desirable for those market participants who prefer the traditional security approach.

Clarification of the ability of a chargee to use charged collateral (“clog on the equity of redemption” point) is also desirable.

*The Collateral Law Reform Group acknowledges the assistance of Freshfields, London in the preparation of this report. That firm, however, accepts no liability in relation to this report.*