KEY POINTS

- The regime in the UK governing financial collateral remains broadly similar notwithstanding Brexit.
- Germany similarly implemented a fulsome financial collateral regime, which does not differentiate between collateral takers situated in a member state of the EU or elsewhere.
- The position in Germany in respect of UK collateral takers is broadly unchanged, but the wider relationship with the EU and the future applicability of EU legislation to such arrangements may have an impact.

Authors Amy Kennedy, Chris Parrott, Markus Käppler and Ahmed Alfreahat

Financial collateral and Brexit: a comparative perspective

The EU directive on financial collateral (EU Directive 2002/47/EC) (Directive), as implemented in the UK remains (with amendments) on the statute book and has not been directly impacted in any meaningful sense by Brexit. However, given the latitude inherent in the Directive, a marginally fractured legislative landscape has resulted across the member states.

BACKGROUND TO THE FINANCIAL COLLATERAL DIRECTIVE

The purpose of the Directive was to facilitate a cross-border framework in respect of the provision of certain types of bilateral financial collateral within the EU.

Recital 3 of the Directive states:

> "[The Directive] will contribute to the integration and cost-efficiency of the financial market as well as to the stability of the financial system in the Community, thereby supporting the freedom to provide services and the free movement of capital in the single market in financial services."

To effect that outcome, the Directive covers the provision of cash, financial instruments and credit claims as financial collateral, and applies to the provision of financial collateral through the use of title transfer arrangements and security financial collateral arrangements.

The applicability of such arrangements gives potent rights to the collateral taker, both generally, and in an insolvency/enforcement scenario. This includes the disapplication of requirements to comply with some national laws, such as security registration formalities, the ability to appropriate financial collateral in certain circumstances, and the disapplication of certain insolvency provisions.

This article aims to provide a high-level overview of the legislative framework in Germany and the UK, and examines whether the UK's new found status as a non-member state has any ramifications.

UK LEGISLATIVE FRAMEWORK

The UK implemented the Directive into domestic law through the Financial Collateral Arrangements (No.2) Regulations 2003 (Regulations) (being secondary legislation passed using the European Communities Act 1972). It has since become part of domestic law.

The ambit of the Regulations is wider than that under the Directive. In particular, the Regulations omitted Art 1 of the Directive, which maintains that the provisions are to apply either to arrangements between a non-natural person and a public or regulated institution, or between two public or regulated institutions. In lieu, the Regulations apply to any relevant financial collateral arrangements entered into between "non-natural persons". This omission, and the generally wider applicability of the Regulations over the content of the Directive, has been the subject of some judicial comment and doubt.[1] It is common, for example, for English law security documentation to contain clauses in respect of the Regulations in the event that they apply to corporate lending and other transactions which have no connection whatsoever with the markets that the Directive was implemented in an attempt to harmonise.

Where a cross-border element applies, it will be necessary to ascertain the governing law of the arrangements through the application of conflict of laws rules, including the provisions of cl 19 of the Regulations, which expressly provide for the governing law of the arrangements where book entry securities are used as collateral and are held through various intermediaries. Consequently, where the arrangements are governed by UK domestic law and so fall within the scope of the Regulations there is no requirement that either party be domiciled in the UK or any other jurisdiction. Brexit did not have an impact on this position, and therefore any financial collateral arrangements which were subject to the Regulations prior to 23.00 on 31 December 2020, should not be affected insofar as the Regulations are concerned.

The Financial Markets and Insolvency (Amendment and Transitional Provision) (EU Exit) Regulations 2019, SI 2019/341 amended the Regulations, by removing references to EU law. Pursuant to the provisions of the European Union Withdrawal Act 2018, the Regulations (as "EU-derived domestic legislation") continue to apply under UK domestic law.

GERMAN LEGISLATIVE FRAMEWORK

As was the case in the UK, the German legislator took a wider approach when implementing the Directive, which was enacted through various existing statutes and codes – predominantly the German Banking Act (KWG), the German Civil Code (BGB), the German Insolvency Code (InsO), and the Law on Deposits of Securities (DepotG). Many of the principles of the Directive already existed in German law; hence, only partial implementation was necessary.

The KWG financial collateral rules apply to transactions between the entities outlined in Art 1 of the Directive. However, the KWG also applies the relevant provisions to listed and private companies and merchants on the

Biog box

Amy Kennedy is a partner, Chris Parrott is Counsel and Ahmed Alfreahat is a trainee solicitor at Akin Gump in London. Email: amy.kennedy@akingump.com; chris.parrott@akingump.com and ahmed.alfreahat@akingump.com

Markus Kaeppler is Counsel at Akin Gump in Frankfurt. Email: markus.kaeppler@akingump.com

proviso that if such an entity is the security grantor, the financial collateral rules will apply only if:

(i) the collateral secures claims arising from contracts for the sale and purchase of certain financial instruments (such as shares in stock corporations and bonds, or similar tradeable instruments), from loans to finance the purchase of such financial instruments, or similar transactions; and

(ii) the financial collateral does not consist in shares of the security grantor or its affiliates.

In the spirit of the Directive, the German regime is particularly relevant for transactions in the interbank market, such as margin calls or close-out netting; whereas the provision of collateral for many types of corporate lending transactions will not qualify.

By way of an example, if a German company were to enter into a credit facility, a pledge of the shares in a German subsidiary of that company would not fall within the scope of the regime on the basis that pledges in shares of affiliates are expressly carved out.

An account pledge would intrinsically constitute financial collateral, but would only fall under the German regime if the account pledge secured claims in connection with those items listed in (i) above.

There are, however, a few German provisions which go beyond the scope of the Directive and the KWG. Sections 1259 and 1279 BGB impose a regime similar to appropriation where the pledge agreement stipulates that a pledgee may enforce the pledge by private "free hand" sale, or that ownership of the pledged asset shall automatically pass to the pledgee when the secured claim becomes payable or is being accelerated, provided that the pledged asset has a (stock) market price. These provisions will consequently apply to a bank account pledge, a pledge of certain securities and precious metals.

Post Brexit, the rules of German international private law governs the relationship between the German and UK financial collateral regimes. Since the Directive was implemented by amending several existing statutes and codes in Germany, one has to look at the relevant conflict of laws rules that in each case apply to that German statute or code. For example, the German conflict rules that apply to a German law account pledge under the BGB are distinct from those that apply to the InsO. As such, the relationship between the German and UK financial collateral regime always needs to be determined on a case-by-case basis.

Sections 1259 and 1279 BGB go beyond the intention of the Directive, are distinct from the rules under the KWG, and are neither limited to financial collateral in a strict sense nor to securing specific types of transactions involving financial instruments. These provisions are not limited to pledgees based in Germany or in the EU, provided that (depending on the type of the pledged asset) the collateral arrangements are subject to German law or the pledged asset is situated in Germany.

The provisions in the Directive governing the treatment of book entry securities were omitted in Germany on the basis that the application of s 17a DepotG achieves a similar outcome. Pursuant to s 17a DepotG, a security interest over book entry securities is governed by the laws of such state which has authority over the relevant securities register or in whose territory the relevant securities account holder is situated. For example, if security is created over a German book entry securities account to secure an English law credit facility, then German law applies.

Many of the provisions in the InsO, such as those concerning close-out netting on an insolvency in s 104 InsO, explicitly refer to and are limited by s 1 para. 17 KWG, and consequently the enhanced insolvency protections only benefit those financial collateral arrangements falling within the KWG. Pursuant to the KWG, the German financial collateral rules also apply if the collateral provider is not domiciled in a member state, on the proviso that the collateral provider is of a substantially similar type as the institutions referred to in Art 1 of the Directive. Although the provision is silent as to non-EU member state collateral takers, there are good arguments that s 1 para 17 KWG applies to them as well, on the basis that the Directive does not discriminate in this regard – for instance, the Directive expressly refers to certain institutions (eg the Bank for International Settlements) which are not domiciled in the EU. There remains, however, some legal uncertainty in this regard. By way of an example, the specific German insolvency collision statute for set-off transactions would usually apply to s 104 InsO in respect of close-out netting if the relevant netting agreement is governed by German law.

CONCLUSIONS

Brexit appears, therefore, and in most cases, to have little effect as regards financial collateral in either the UK or in Germany. Accordingly, the position of UK companies in German courts where German law governed financial collateral is concerned is unchanged as regards the financial collateral regime per se: what will be decisive is the conflicts of law regimes applicable in Germany. In particular, it remains unclear and should be assessed in each case what effect the continued applicability of other EU legislation (including in respect of EU Regulation 2015/848 (recast) (the Recast Insolvency Regulation)) and the wider financial services relationship with the EU in the future will have on such arrangements. ■

1 *United States v Nolan* [2015] UKSC 63, *Cukurova Finance International Limited v Alfa Telecom Turkey Ltd* [2013] UKPC 2.

Further Reading:

- Validation of the Financial Collateral Arrangements Regulations post-Brexit: legal considerations (2021) 4 JIBFL 250.
- Drafting for Brexit in finance documents (2020) 11 JIBFL 727.
- LexisPSL: Banking & Finance: Practice Note: Key provisions of the Financial Collateral Regulations.