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Secured Lending and the Financial Collateral Arrangements Law

Introduction

There are special rules for security over financial collateral. These derive from the EU Directive on Financial Collateral Arrangements (2002/47/EC) (the “**Directive**”) which was brought into force in Cyprus by the Financial Collateral Arrangements Law (43(I)/2004) (the “**FCA Law**”).

The purpose of the FCA Law, as of the Directive, is to simplify the procedures across the EU for taking and realising financial collateral (whether by way of security or outright transfer) and to protect such arrangements from insolvency rules that might otherwise undermine them.

This Briefing provides an overview of the main provisions and the implications of the FCA Law for parties entering into financial collateral arrangements under Cyprus law.

Application of FCA Law

To enjoy the benefits of the FCA Law, an arrangement must satisfy certain specified requirements as to:

- (A) the type of arrangement covered; and
- (B) the parties involved;
- (C) the obligations covered; and
- (D) the assets which constitute the collateral.

(A) *Type of Arrangement*

The FCA Law covers two types of financial collat-

eral arrangement:

- “*title transfer financial collateral arrangements*”, where title to the financial collateral is transferred by the collateral-provider to the collateral-taker with the intention of transferring it back to the collateral-provider when the obligations have been discharged (for example, a repo agreement or a stock lending arrangement); and
- “*security financial collateral arrangements*”, where a security interest in the financial collateral is created coupled with the financial collateral being in the possession or under the control of the collateral-taker or a person acting on its behalf. Because of the wide ambit of the FCA Law, even relatively straightforward security arrangements such as a share security or security over a bank deposit, may fall within the scope of the FCA Law .

(B) *Parties*

The financial collateral arrangement must be made between two parties (other than individuals), one of which must be a public authority, central bank, supervised financial institution or clearing system; and

(C) *Obligations*

Any obligations that are “secured or otherwise

covered” by a financial collateral arrangement would be relevant financial obligations for purposes of the Regulations, so there should be no difficulty in satisfying this requirement in practice.

(D) *Financial Collateral*

“*Financial collateral*” is defined in the FCA Law as “cash” and “financial instruments”.

“*Cash*” is defined as:

- money credited to an account in any currency; or
- a similar claim for repayment of money (including money market deposits).

“*Financial Instruments*” is defined as:

- shares in companies and other securities equivalent to shares in companies;
- bonds and other instruments acknowledging indebtedness if they are tradeable on the capital market; and
- any other securities which are normally dealt in and give the right to acquire any such shares, bonds, instruments or other securities or which give rise to a cash settlement (excluding instruments of payment).

Issue of ‘Possession’ and ‘Control’

In the case of a security financial collateral arrangement, the financial collateral must be in the possession or under the control of the collateral-taker or a person acting on its behalf. Unfortunately, neither the Directive nor the FCA Law provide a definition of what is meant by ‘possession’ or ‘control’. This uncertainty creates particular problems in the context of floating charges, but may also be an issue in the case of other security interests. We consider below how the FCA Law may impact traditional security arrangements involving share and cash security.

Share and Cash Security

Registration of security over shares in a Cypriot company is not required under section 90 of the Companies Law, 113 (the “**Companies Law**”).

The registration of security over:

- shares (whether in registered or de-materialized

form) in a non-Cypriot company;

- the balance standing to the credit of a bank account; and
- bonds or other debt securities,

is generally required under section 90 of the Companies Law.

Under the FCA Law, provided possession and control over the financial collateral can be established and in the case of bonds, they are tradeable on the capital market, it should no longer be necessary to register such security.

However, if there is any doubt about whether FCA Law applies, the security should be registered.

Main practical points if the FCA Law applies

- Perfection requirements: where a pledge over shares is granted, the perfection requirements set out of section 138 of the Contract Law, Cap. 149 relating to the form and manner of execution of the pledge document, do not need to be satisfied. As a result, the only formalities applicable to a financial collateral arrangement is that it should be in writing.
- Registration requirements: where cash or securities are secured (as part of a security financial collateral arrangement) there is no need to register the charge under section 90 of the Companies Law.
- Avoidance of contracts and floating charges: a financial collateral arrangement may not be declared invalid or reversed solely on account of it coming into existence in a prescribed period prior to or after the commencement of the winding up of a company under the following provisions:
 - Section 216 of the Companies Law relating to the avoidance of dispositions of certain property after commencement of winding-up.
 - Section 217 of the Companies Law relating to the avoidance of attachments after commencement of winding-up.
 - Section 265 of the Companies Law relating to the avoidance of transfers of shares after commencement of winding-up.

- Section 301 of the Companies Law relating to fraudulent preferences.
- Section 303 of the Companies Law relating to the avoidance of certain floating charges.
- Section 304 of the Companies Law relating to the disclaimer of onerous property in case of a company being wound-up.
- Modification of “zero hour rule”: the FCA Law clarifies that, where on the day, but after the moment of commencement of winding-up proceedings or reorganization measures, a financial collateral arrangement comes into existence, then this will be legally enforceable and binding on third parties if the collateral-taker can show that he was not aware, nor should have been aware of those proceedings or measures. Therefore the following provisions do not apply in relation to a financial collateral arrangement:
 - Close-out netting: close-out netting agreements will take effect in accordance with their terms, even if the collateral-provider or collateral-taker is subject to winding up proceedings or reorganization measures, unless, that party was aware or should have been aware that winding-up proceedings or re-organization measures had commenced in relation to the other party.
 - Right to use collateral: The right of the collateral-taker to use collateral as if it were its own, even where the collateral is provided on the basis of a mortgage or charge, is confirmed. The right to use the collateral must be contained in the relevant financial collateral arrangement and should clearly set out the contractual and proprietary effect of permitting the right of use. If the collateral-taker uses the collateral it must either replace the collateral with equivalent collateral or set the value of equivalent collateral off against the secured obligations.
 - Right to appropriate collateral: a collateral-taker can appropriate financial collateral in accordance with the terms of a financial collateral arrangement without having to apply to a court for an order. However, appropriation is only possible if it has been agreed by the parties in the security financial collateral arrangement; and the parties have agreed on the valuation of the financial collateral. Where a collateral-taker

has appropriated financial collateral it must give value for the collateral in accordance with the terms of the arrangement and in any event in a commercially reasonable manner.

- Book-entry securities used as collateral: where the security is over book-entry securities held through one or more intermediaries, the FCA Law clarifies that the law applicable to determine the validity of the collateral arrangement (and related proprietary issues) is the law of the country in which the relevant account is situated.
- Floating Charges: so long as the collateral-taker (or its agent) is given possession of or control over the financial instruments it will not matter whether the charge (if it is part of a security financial collateral arrangement) is fixed or floating. A right for the collateral-provider to substitute equivalent collateral or remove excess collateral will not prevent the financial collateral being in the possession or under the control of the collateral-taker.

If the FCA Law does not apply

Not all mortgages, pledges or charges will be covered by the FCA Law. There will still be many transactions under which security over cash or securities is granted but where the FCA Law will not apply. In these cases the law is not changed. It is less likely (but still possible) that a title transfer collateral arrangement could be entered into where the FCA Law does not apply.

Because taking and realising security over cash and securities has always been relatively easy in Cyprus, the impact of implementing the Directive is not as great in Cyprus as it will be in some other EU Member States. If the FCA Law does not apply, it will be necessary to register some mortgages, pledges or charges which would not need to be registered if the FCA Law does apply.

Conclusions

The FCA Law will not have any major impact on secured lending techniques. Where they apply their effect will, however, be beneficial.

For the creditor, the benefits should be an increased certainty of payment through the ability to retain or realise collateral. For the debtor, the benefit may be a reduction in transaction costs through cheaper pricing as a result of the reduced risk where financial collateral is taken.

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