European financial markets have grown hugely over the last 25 years, leading to higher transaction volumes, the concentration of financial instruments in central securities depositories (national and international) and the clearing of a wider range of transactions through clearing houses. The use of cash, financial instruments and credit claims as collateral has become a crucial tool to enable market participants and central counterparties ('CCPs') to manage credit risk, the importance of which has been demonstrated by the global financial crisis of 2008 and its aftermath.

The use of financial collateral will increase even further as the European Markets Infrastructure Regulation ('EMIR')\(^1\) is implemented. Once fully implemented, the volume of cleared derivative transactions in the European Union is expected to be approximately €77.9 trillion and the volume of non-cleared derivative transactions is expected to be approximately €74.9 trillion. Both cleared and non-cleared transactions will need to be supported by collateral.\(^2\)

The global supply of high-quality collateral assets is estimated at around €41 trillion, out of which €31 trillion is available for use. Collateral eligible to meet the market infrastructure requirements of EMIR is estimated at €28 trillion. Collateral eligible to meet the requirements of CCPs is estimated at between €3 and €14 trillion for CCP-cleared repos and €5 and €28 trillion for initial margin with CCPs.\(^3\)

The law relating to financial collateral, particularly in cross-border transactions, is relatively recent and largely derives from the Financial Collateral Directive.\(^4\) Many other changes in law and regulatory practice have been introduced since the financial crisis of 2008 which affect the treatment and use of financial collateral. Because of its importance and the magnitude of the amounts involved, the whole subject deserves a book to itself and this volume is intended to fill that gap.

The book falls into two parts. The first part explains the law created by the Financial Collateral Arrangements (No. 2) Regulations 2003 which implemented the Directive (the full text of both the Directive and the Regulations are set out in

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1 Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories.
2 European Supervisory Authorities, Consultation Document on risk management procedures for non-centrally cleared OTC derivatives, 14 April 2014, p. 56. The above figures are based on total gross notional amounts estimated to be outstanding under derivative transactions. The figures appear to allow for an increase between the date of compilation and the date when the central clearing obligation was then expected to be fully implemented.
3 European Central Bank, Collateral Eligibility and Availability, July 2014, pp. 4, 12. The figure for collateral available for use is stated to take into account the fact that not all collateral is accessible to market participants as a certain portion is blocked on accounts with central securities depositories or custodians or held in non-actively managed portfolios.
Appendix 2). In particular it examines the steps required to satisfy the ‘possession’ or ‘control’ test for the purpose of creating an effective security financial collateral arrangement; the benefits offered by the Regulations; the extent to which they disapply insolvency law in relation to financial collateral arrangements; the impact of the new special resolution and ‘bail-in’ regime for financial institutions; conflict of laws; and novel features introduced by the Regulations, such as the right of use and the remedy of appropriation.

The second part is broader in scope and examines how financial collateral is used in a range of different markets. It deals with how security over financial collateral is taken and perfected, including where financial instruments are held in uncertificated form in CREST or in book entry form in an indirect holding system such as Euroclear Bank (Belgium) or Clearstream Banking (Luxembourg); how financial collateral and close-out netting are used in the derivatives market; how recognised clearing houses operate and how they take and rely on collateral; how financial collateral arrangements are treated for regulatory purposes; and what margin requirements apply to non-centrally cleared derivatives. It also examines special issues arising from the use of financial collateral in repos, securities lending and prime brokerage and the treatment of client assets. Many of these issues have arisen in the litigation flowing from the collapse of Lehman Brothers International (Europe) and MF Global UK Limited. Finally, we look to the future with a chapter on law reform.

As this area of law is not free of jargon, the book includes a table of abbreviations and a glossary of terms. We hope that readers will find these helpful.

The book is written primarily from the perspective of English law but includes a chapter and commentary elsewhere on the position under Scots law. It does not address any questions of consumer protection or taxation.

We are honoured and particularly pleased that Lord Hoffmann has provided a Foreword. His outstanding contribution both as a judge and as Chairman of the Financial Markets Law Committee to the development of the law and to resolving legal uncertainties affecting the UK financial markets is well known.

We are deeply indebted to Edward Murray for finding time, despite his heavy work load and judicial duties, to contribute Chapters 13 and 17 and to Hamish Patrick for contributing Chapter 23 and the commentary on Scots law generally. We are also indebted to Mark Evans for his expert assistance on CREST-related matters in Chapter 16; to John David Thiede for his contribution on client assets in Chapter 18; to Michael Thomas for his contribution on the clearing and settlement of transactions in Chapter 20; to Caitlin McErlane and Max Savoie for their contribution on the BCSB-IOSCO framework and the Securities Financing Transactions Regulation in Chapter 22; and to Matthew Dening for reviewing and commenting upon many of the chapters in the first part of the book. The book as a whole greatly benefits from their combined knowledge and experience.

The authors of first drafts of the chapters were as follows:

Geoffrey Yeowart: Chapters 1, 2, 5, 12, 15 (except Part D), 16, 19, 20, 21, 22 (Parts A and B) and 24 (Parts A-C, E and H).
Robin Parsons: Chapters 3, 4, 6, 7, 8, 9, 10, 11, 14, 15 (Part D), 18 and 24 (Parts D and F).
Edward Murray: Chapters 13 and 17.
Hamish Patrick: Chapters 23 and 24 (Part G).

Each of us as principal co-authors has collaborated closely with the other and with our contributing authors to produce the book as a whole. Our contributing authors have been concerned only with their own individual contributions.

As this is a developing area of law, we have tried where possible to provide guidance on issues of importance to practitioners even if there is no relevant case law. In many cases, the legal position is not free of doubt and the views expressed are simply expressions of our personal judgement on how the issues are likely to be decided if they come before the courts. The views expressed by us and other contributors are not necessarily those of the law firms and professional bodies of which we, or they, are members.

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This book has been written at a seminal stage in the development of English and Scottish financial law. Since the 2008 financial crisis, the legal framework has been radically reshaped and may remain in force for decades to come. Although further regulations and technical standards may be required to implement it fully or develop it further and guidance may be required to clarify various aspects, the building blocks for the new structure are now largely in place.

The law is stated at 1 January 2016. This book is intended to provide guidance only. It is not a substitute for legal advice on a specific question or transaction.

Geoffrey Yeowart and Robin Parsons