Pledging Accounts — are you Like the EU?

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The stress-testing of secured instruments in 2009-2014 has exposed a lack of clarity in statutes, weak interpretation skills by courts and a knowledge gap present in regulators and the legislature. The DCFTA between the EU and Ukraine gives a helpful hand in this respect: it offers a good view on the functioning of security instruments of the modern interdependent economies operating in 28 various legal environments and able to achieve commercial goals. For secured transactions, financial pledge directives: 2002/47/EC, 2009/44/EC and 98/26/EC can be found to be particularly useful. Taken in the historical prospective, member states proceeded from the finality of settlement in the security-trading systems under 98/26/EC to the pledge of cash under 2002/47/EC and, finally, collateralization of credit claims pursuant to 2009/44/EC.

Our analysis of the gaps in Ukrainian legislation will concentrate on the pledge of securities accounts (depositary system) and cash (banking system). For avoidance of doubt, the financial pledge and Directives do not extend to banknotes and physical precious metals; the scope of the pledge is restrained to accounts denominated in various currencies, IMF SDRs, precious metals. While the above Directives also set the benchmarks for trading in credit claims, it should, in our view, have a setting similar to the pledge of securities but with fewer formalities for the issue of the instrument and its offer to the market.

To whom it may concern

It must be noted that financial pledge arrangements concern only ongoing enterprises, while consumers (households, individual consumption) are not affected.

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Moreover, the laws of Ukraine can test transposition of EU Directives on systems with central counterparty, such as the electronic payments system (EPS) of the National Bank of Ukraine, the depository network of the National Depository of Ukraine, the Settlement Centre for Servicing Financial Market Agreements, etc.

It is worth noting that the National Depository of Ukraine will be eventually mandated to coordinate its activities with Euroclear and Clearstream as a counterparty and, therefore, will have to ensure the compliance of the Ukrainian legal environment with their general terms and conditions which, in their turn, equal or exceed the objectives of the Directives. Since 2010, the National Depository of Ukraine has been a customer of ICSD Clearstream Banking Luxembourg[1].

Thus, the provisions of the financial pledge will apply to the central counterparties: the NBU, the NDU, the Settlement Centre, the stock exchange, and to the members (direct participants) of the centralized system: banks, depositaries, credit institutions, professionals on the securities markets, international financial institutions (EBRD, IFC, EIB, etc.). Furthermore, the predictability of settlement and reliability of enforcement in the system can be accessed, through the agreements with members, by indirect participants: corporate legal entities and partnerships not involved professionally in the investment activities.

Finality of the clearance

For the substance of the financial pledge, finality of the settlements looks a collateral issue. However, the powerful market infrastructure that operates on a country-wide or even cross-country scale is capable of executing millions of transactions per second and it would be a nightmare to unwind transactions entered by an insolvent counterparty, such as a bank, for the last 12 calendar months. Accordingly, Directive 98/26/EC of the European Parliament and of the Council (OJ 11.6.98) deals with insolvency and inter-jurisdictional issues: it provides, *inter alia*, that transfer orders be irrevocable and remain legally enforceable and binding upon the third party even where one of the parties becomes insolvent. The Directive further requires that transactions from the correspondent account at the central counterparty may be finalized on the day when the moratorium is declared by the judge. In such an event, even transactions of an indirect participant can be shielded from the moratorium imposed by a bankruptcy court[2].

Moreover, not only regular enforcements (i.e. appropriation of collateral to repay the loan) must remain intact, but close-out netting provisions of the contract cannot be set aside[3]. Central banks, central counterparties and other participants of the system must remain secured creditors able to satisfy their claims against the collateral provided by the insolvent participant along with conventional pledgees — direct and indirect participants of the system[4].

Ukrainian legislation fails to achieve the above objectives. The ir-

[1] Cf. http://www.csd.ua/index.php?option=com_content&view=article&id=4538&Itemid=277&lang=en, last visited on 6 April 2015.

[2] Directive 98/26/EC, Articles 3.1, 3.3 and 5.

[3] Ibidem, Article 3.2. Note: close-out netting provides for enforcement against the part of the collateral; the rest of the claim to the debtor is offset unilaterally against the debtor's claims to the creditor. Thus, the offsetting creditor is privileged during a moratorium and, theoretically, gets the highest ranking in the insolvency.

[4] Ibidem, Article 9.1.

revocability of the transfer orders can be achieved through amendment of the regulation by the National Commission on the State Regulation of Securities and the Stock Market; the Government of Ukraine and its agencies are also able to designate the systems where the rules apply, e.g. the stock and currency exchanges, the depository system, the NBU system of electronic payments, SWIFT solutions, etc. However, application of the insolvency principles and the technical equipment for announcement of the insolvency, reorganization or winding up must be made through amendment of the law.

Management of accounts

EU directives require that the law recognize and uphold transfer of the collateral to the pledgee before the enforcement so that the pledgee can enjoy the title and use the collateral. Securities can be lent, transferred into management or become subject of a repo agreement; cash can be placed into management of the creditor or made subject to the creditor's veto.

The Ukrainian legal system is fraught with Soviet legacy, with its lack of respect to private property or ownership title in general. Therefore, courts and society have an emphatically cautious approach to restricting entitlements even if it is self-imposed. The regulatory approach assumes the personal nature of the entitlement to manage the account (whether denominated in securities, cash or precious metals); in other words, delegating management of the account is viewed as temporary and reversible: the owner of the securities / holder of the bank account is incapable of entering into a fiduciary management agreement or issuing irrevocable powers of attorney.

Unlike management of a mortgaged collateral by the mortgagor, the pledge law does not expressly permit management of securities or cash by the pledgee; moreover, in case of fiduciary management, the law seem to prohibit (and rightfully so) that the beneficiary becomes the asset manager;[5] therefore, the measures on the asset management in the judgement on involuntary enforcement[6] will likely involve an independent party.

[5] Civil Code, Article 1033.3.

The financial pledge Directives require that enforcement against the collateral should not comprise (i) a prior notice, (ii) a waiting period or (iii) a public auction

For agency relations based on the power of attorney, the creditor is likely to have a conflict of interests — as the agent of the owner, he cannot transact with himself[7] and, therefore, appropriation or even sale of the collateral can be claimed *ultra vires* by the pledgor. The depositary cannot grant full or partial access to the account based on the pledge (blocking) agreement nor does the bank of the account recognize the binding nature of the provisions (in the bank account pledge agreement), which give the creditor veto powers or transfer the management of the account to the creditor. The law on pledge and encumbrances should provide for special rules for management and transfer of title to the securities and/or the monetary claims, while the laws on payment systems and the securities should include the relevant cross-references.

Swift enforcement

The financial pledge Directives require that enforcement against the collateral should not comprise (i) a prior notice, (ii) a waiting period or (iii) a public auction[8]. The *On Securing the Creditors' Rights and Lien Registration Act* falls short of achieving the first two benchmarks and the *On Pledge Act* requires the opposite of the third one[9]. Given substantial transaction costs for the membership and substantive know-your-client policies with respect to indirect participants, centralized systems deserve simplified enforcement of pledge arrangements.

At the same time, the Directives are concerned with reasonable valuation of the collateral so that swift enforcement does not affect fairness to the debtor. Ukrainian law, quite distinctly, relies on the freedom of contract[10]; an amendment on the valuation of the collateral during the sale needs not be restricted to the centralized systems only.

[6] On Securing the Creditors' Rights and Lien Registration Act of Ukraine, Article 25
[7] Civil Code of Ukraine, Article 238.3.
[8] Directive 2002/47 Article 4.4.
[9] Article 21.
[10] Idem. By default, the sale should be made through a public auction and thus, market forces, but the organization of auctions is loosely regulated and, therefore, is easily manipulated. Besides, the parties are free to derogate from the auction.

Law-making flaws

The practical importance of secured transactions has been largely understood by the market but not scholars and policy-makers. While the academic doctrine lags behind with comments of the statutes business practice has been integrating innovational solutions of the EU and North American economies.

The legislature and the regulators have on numerous occasions failed to support positive trends on the market. For example, to provide more detailed and flexible collateral instruments, such as pledge of cash and securities; ensuring secured transactions with the title of the transfer: fiduciary management, repo agreements, close-out netting.

Policy-makers mishandled the negative trends, such as enforcement on personal mortgages, repossession of leased assets by owners, sale of non-performing loans and portfolios by credit institutions, avoidance by pledgor of a floating charge (e.g. pledge of the warehoused articles and commodities) or car liens through diversion of assets, let alone suretyships.

Regulatory moves in the prudential supervision of the latest 12 months have not undone the harm inflicted earlier. Moreover, the foreign exchange crisis resulted in a number of administrative measures against mitigation of the devaluation risks. Thus, ensuring that collateral provides sufficient value in case of a default becomes an ever more important goal. The policy-makers must bring the market stakeholders to the discussion platform, quite in line with the law on the regulatory activity and, importantly, employ academic research to develop sustainable changes to legislation.

Pledge of securities

Ukraine has pretty advanced legislation on the pledge of securities and a relatively insignificant gap with the objectives of Directive 2002/47/EC of the European Parliament and of the Council (as amended by Directive 2009/44/EC of the European Parliament and of the Council). The pledge of securities was significantly improved in 2013-2014, so that the mechanics of the transfer orders, namely their finality, enforcement and appropriation by the pledgee, only need fine tuning.

The "top up" provision of the pledge agreement enabling amendment and replacement of the collateral is an industry-specific objective that the law failed to accomplish. To allow top up and avoid frequent execution of modifications to the pledge agreement (i.e., give the debtor a freedom of business judgement when it comes to transacting with his assets), the pledge agreement must define the collateral as a type or form of securities (capped at the aggregate value) and subject to a floating charge. Securities of the same issue are a highly regulated and unique asset. If the concurrent pledge agreement determines the collateral more precisely (e.g. the issuer, the face value, the percentage of the total issue, the details of the global certificate (if available) are indicated), it is likely to prevail over the creditor that registered only generic information on the collateralized securities. The law should restrict the creditors with a lower ranking from enforcement against the collateral, where such enforcement may affect the collateral with more generic description under the pledge with a higher priority.

Another possible enhancement is clarification of the possibility to offset (exercise close-out netting) mutual claims denominated in securities.

Pledge of cash

Funds in cash and, less obviously, precious metals, have no issues in performance of the close-out netting and top-up provisions outside insolvency proceedings. The pledge bank account, however, has a doctrinal ambiguity: most banks understand the cash in a bank account as a contractual claim based on the agreement while the National Bank of Ukraine speaks rather of the pledge of the "monies"[11] — in other words, equivalent of banknotes. The ambiguity is a point of bifurcation: enforcement against the contractual claim as collateral requires assignment, while money as collateral must be handed directly, transferred through the payment system or deposited to a safe of the notary. The ambiguity might have started with the Decree on the foreign currency regulations, which requires a licence for the use of foreign currency as collateral[12]. This theoretical discussion is disruptive to the modernization of the financial instrument. To cut on the analysis of all historical arguments, we suggest that bank accounts are recognized as a monetary claim to the bank based on a contract. This interpretation will not only be consistent with the insolvency law[13], but will follow the business and judicial practices of the EU. It would be helpful if the NBU amends its Instruction on the accounts or at least issues an opinion letter in this respect.

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From the above prospective, savings accounts can be relatively freely pledged but this instrument offers freezing the funds for an uncertain period with few benefits such as interest. Besides, the voluntary (extrajudicial) appropriation of the deposited funds requires transit of cash through the current account of the pledgor[14]; this may be impossible if the latter does not cooperate. The NBU should explain the option of enforcing against the funds on the savings account without their transit through the current (checking) account. Additional options should also be provided in the currency regulations if the principal obligation was denominated in a currency different from the currency of deposit.

Although suitable for letters of credit and guarantees, a savings account is clumsy collateral in project financing. Banks, however, believe in the somewhat unusual nature of the Ukrainian current (checking) account in Ukraine. They are content that the funds on such accounts cannot be blocked by the bank for the benefit of a third party on contractual grounds. Thus, although current (checking) accounts can be pledged for the benefit of the creditor (e.g. bank other than the bank of the account), the bank of the account would do nothing to comply with the pledge terms or to enforce the pledge. This is appalling in the face of provisions in the *Civil Code* that allow contractual restriction of the transfers from the current (checking) account[15]. The banking system of Ukraine remains under the spell for quite a few years now without the courage to offer special purpose checking accounts in multilateral project arrangements or to supervise the terms of the cash pledge. Therefore, the regulator should stimulate contractual arrangements to encumber bank accounts of the legal entities — in line with the Directives — to secure the principal obligation other than the account or overdraft agreement.

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[11] Cf. Instruction On Procedures for Opening, Use and Closing of the Accounts Denominated in the National and Foreign Currencies approved by the NBU Board by Resolution No. 492 of 12 November 2003, Sections 9.6, 15.4 and 16.12.

[12] Decree of the Cabinet of Ministers of Ukraine On the Currency Regulation and Currency Control System of 19 February 1993, Article 5.4(r).

[13] I.e., the legal entities — depositors and other account holders are ranked pari passu with other general contractual creditors of the insolvent bank.

[14] See footnote 11 supra.

[15] Civil Code of Ukraine, Articles 1066.3, 1067.2, 1068.1.