Equitable mortgages over CREST securities

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INTRODUCTION

This guidance note addresses some of the issues which may arise where an equitable mortgage is taken over CREST securities constituted under English law. It assumes that English law governs:

- the mortgage; and
- where relevant, the insolvency proceedings to which the mortgagor is subject.

Although the guidance note is concerned principally with corporate mortgagors, many of the issues addressed are relevant to an equitable mortgage granted by an individual.

The CREST system includes a facility known as the escrow function, which enables one CREST member to give effective control over securities held by him to another CREST member. The escrow function was developed specifically for use as a means of supporting takeover acceptances but may also be used in connection with equitable mortgages or charges (the expression 'mortgage' is used in this guidance note to embrace both).

In brief, in the context of a mortgage, the CREST member who is the mortgagor inputs to the CREST system a Transfer To Escrow (TTE) instruction. Upon settlement, the TTE moves the relevant securities from the available balance used for general settlement purposes to an escrow balance within the membership of the mortgagor. There is no transfer of legal title and the name entered on the relevant issuer's register remains that of the mortgagor. However, once the securities are in the escrow balance, the mortgagor no longer controls the securities and control is ceded to the other CREST member whose identity the mortgagor specified in his TTE input. In system terms this other member is called the 'escrow agent' and could either be the mortgagee himself or any CREST member acting on behalf of the mortgagee.

After settlement of the TTE, the mortgagee can input a Transfer From Escrow (TFE) instruction either to return the securities back in to the control of the mortgagor (e.g. upon repayment of a loan) or to transfer them to himself (e.g. as a step in enforcing the mortgagee's security upon a default by the mortgagor).

Where a CREST member is 'enabled' (that is to say, the member is operating its CREST account normally and is able to deliver and receive securities, etc.) at the time a TFE is input, that TFE will settle in the normal manner described in the *CREST Manual* and this guidance note does not address any issues related to this area. However, a number of important issues arise both in relation to system functionality and in the context of a mortgagee seeking to use a TFE to exercise his rights under a mortgage in circumstances where the member has been suspended in CREST, of which mortgagees and their advisers should be aware.

This guidance note assumes throughout that the mortgagee is himself, in system terms, the escrow agent, that his rights are established under a valid security document (although it is acknowledged that in principle an equitable mortgage may be validly created without the requirement for documentation) and that the mortgagor has complied with the relevant provisions of the *CREST Terms and Conditions* in respect of escrow functionality (in particular clause 12).

This guidance note does not address the floating charge arrangements in connection with which securities in a member account may be linked to a cap or the action to be taken by a CREST payment bank to exercise its rights under such a charge (the Financial Markets and Insolvency Regulations 1996 are relevant in this context). The floating charge arrangements are described in the *CREST Manual*.

Important
This note is for guidance only. It is the responsibility of mortgagees and their own legal advisers to determine the suitability of CREST system functionality and of the suggestions made in this guidance note for their purposes. Neither CRESTCo Limited nor any of its advisers take any responsibility for or in respect of this guidance and nothing in this note represents advice by CRESTCo Limited or any of its advisers to any person.

If you have any questions on this guidance note, please contact the **Euroclear UK Legal team** at UK-Legal@euroclear.com.

GENERAL ISSUES

Treatment of corporate action entitlements (other than on a transformation)

The existence of an equitable mortgage is not known to the issuer of the securities which the mortgagor has provided by way of security to the mortgagee (or to the issuer's registrar). Consequently, the issuer will issue any additional securities (such as under a bonus issue, issue of nil paid rights, etc.) direct to the registered holder (the mortgagor) and not the mortgagee. For this reason, mortgagees often provide in their security documentation that:

- the mortgage in his favour is expressed to extend to such additional assets; and
- the mortgage is supported by a contractual 'further assurance' from the member in favour of the mortgagee that the member will transfer any such securities (if uncertificated) to the escrow balance in the mortgagee's favour or will deliver to the mortgagee physical documents of title.

Equally in CREST, the existence of the escrow arrangement and the identity of the mortgagee are likewise not known to the issuer or reflected in any way on the issuer's register. Therefore, just as outside CREST, when additional securities are to be issued, the registrar directs them to the mortgagor's relevant CREST member account; he does not specify whether the securities are to be credited to the member's available balance or escrow balance.

Where the underlying securities from which the new securities are derived are held in an escrow balance and the registrar identifies the distribution as a corporate action in CREST Corporate Actions Data, the CREST system first checks that the underlying securities are not the subject of a takeover offer (by reference to the CREST corporate actions database) and then directs the credit of the derivative securities to the escrow balance rather than to the available balance. Where units of the same securities are credited both to the available balance and the escrow balance of the CREST member, the CREST system pro-rates the allocation of the additional securities accordingly.

Transformations (including on consolidation and sub-division)

Where a corporate action results in a security being transformed (e.g. on a consolidation or sub-division), one line of securities with a particular ISIN is replaced by a different line of securities with a different ISIN. As noted above, the relevant issuer and his registrar have no knowledge of the credit of securities to an escrow balance. The CREST system applies the same procedure described above and pro rates the credit of the new line of security between the available balance and escrow balance as appropriate.

As may be seen from the descriptions above of the CREST system processing of additionally issued securities and transformations, the re-directing of new issued securities to an escrow balance provides a valuable support to a mortgagee wishing to rely upon and enforce any further assurance covenants set out in his security documentation. In particular, it removes the exposure which the mortgagee would otherwise have to the honesty and efficiency of the mortgagor in transferring to him any such securities voluntarily (as exists, for example, in the context of a mortgage over certificated securities).

Optional corporate actions (e.g. takeovers and conversions)

Special arrangements may be needed where securities are the subject of an optional corporate action during the time the securities are held in an escrow balance in the context of a mortgage. For example, generally a registered holder accepts a takeover offer or exercises conversion rights by delivering the securities to a receiving agent (in these two examples, being the receiving agent of the offeror and the issuer respectively). If the mortgagor wishes to take part in an optional corporate action in this way, he will need the co-operation and agreement of the mortgagee. The mortgagee will need to release the shares from the escrow balance back to the mortgagor's available balance (using a TFE instruction) so that the mortgagor can then take the necessary action.

Outturn securities resulting from optional corporate actions (e.g. consideration securities issued by an offeror after a successful takeover offer or outturn securities resulting from a conversion) are generally delivered to CREST members within CREST by the receiving agent (by transaction types Unmatched Stock Event (USE) or Delivery (DEL)) rather than credited directly into the member account by the issuer's registrar (by transaction type Registrar's Adjustment (REG)). It is not possible for the CREST system to apportion such outturn securities directly to an escrow balance in the manner described in earlier sections in this guidance note. Consequently, mortgagees may wish to include in their security documentation further assurance provisions so as to bind the mortgagor to transfer any outturn securities to an escrow balance in favour of the mortgagee (or, if certificated, to deliver the documents of title to the mortgagee).

SUSPENSION OF CREST MEMBERS

CRESTCo has the power within the *CREST Terms and Conditions* to suspend a membership in a range of circumstances, including (in broad terms) where the member has become, or appears at risk of becoming, insolvent. The effect of suspending (or 'disabling') a member is that no further settlement may take place involving the suspended member: an important purpose of this power is to protect other members from the risk of legal challenge which might otherwise arise in relation to any transactions settled and registered through CREST after the commencement of insolvency proceedings. Generally speaking, this suspension is likely to be lifted subsequently once the insolvent member is under the control of an insolvency practitioner. It is also possible that a member may be suspended in some non-insolvency-related circumstances (e.g. where the member has been suspended for some operational reason or for breach of certain CREST Rules).

Suspension of a member would ordinarily prevent a TFE instruction to the CREST system by a mortgagee from settling (e.g. in order to transfer the relevant securities to his own membership in order to realise or perfect his security). However, the CREST system allows a TFE instruction to settle notwithstanding the suspension of the member, subject to the specific consent of CRESTCo. A mortgagee may therefore request that CRESTCo gives its consent to allow one or more specific instructions to be input and settled. In granting or withholding its consent, CRESTCo will have regard to the particular circumstances relating to the suspension. As a general matter, and without limitation, CRESTCo would expect to withhold its consent (subject to any relevant disapplication of insolvency laws under the Financial Markets and Insolvency Regulations 1996 and/or the Financial Markets and Insolvency (Settlement Finality) Regulations 1999):

- where as a matter of insolvency law the mortgagee may not enforce his security rights (e.g. sections 10(1)(b) and s11(3)(c) of the Insolvency Act 1986 place certain restrictions upon the enforcement of security upon the presentation of a petition for an administration order and the making of such an order); or
- where settlement of the TFE would in any way interfere with the orderly operation of CRESTCo's or any other Recognised Clearing House's or Recognised Investment Exchange's default rules and arrangements.

As a general matter, and without limitation, CRESTCo would expect to grant its consent:

- where the member's suspension is not related to insolvency;
- where the court or relevant office holder has granted its consent to the realisation of the mortgagee's security; or
- where there is no other obstacle in insolvency law (as modified by the Financial Markets and Insolvency Regulations 1996) to the mortgagee realising his security.

More generally, if an administration order is made and the administrator requests that CRESTCo re-enable the membership to enable him to carry out his functions, CRESTCo makes it a condition of doing so that the administrator acknowledge that a TFE instruction input by a mortgagee may then settle and that he give his consent to any such realisation of security. A mortgagee should nevertheless obtain the consent of the administrator or leave of the court before inputting a TFE instruction as a step in the enforcement of his mortgage.

TERMINATION OF CREST MEMBERS

At a point following suspension in insolvency-related circumstances CRESTCo will normally proceed to terminate the member's participation in CREST and recertificate the member's holdings of securities in CREST. (The precise timing of a membership termination cannot be indicated with certainty, but generally, the membership is only terminated at the request of the relevant office holder, often many months after the commencement of insolvency proceedings.) On recertification, the issuer's registrar will ordinarily deliver any certificates to the terminated member at his registered address (as the registrar has no knowledge of the existence of the escrow arrangement or the identity of the mortgagee). Mortgagees may therefore wish to ensure that their security documentation deals appropriately with holdings of the relevant securities whether in certificated or uncertificated form and includes a security power of attorney applicable to both. They may also wish to consider what practical arrangements they might make to obtain control of the certificates delivered or to be delivered to the terminated member on recertification.

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