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Chairperson
Committee on Economic and Monetary Affairs
European Parliament
Rue Wiertz
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2 November 2004

RE: EFMLG VIEWS ON PROTECTION FOR BILATERAL INSOLVENCY SET-OFF AND NETTING AGREEMENTS UNDER EC LAW

Dear Sirs and Madam,

The European Financial Market Lawyers Group (EFMLG)[1] has published the enclosed report identifying various legal uncertainties on the enforceability of contractual set-off and netting agreements that result from certain provisions of:

- Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings[2] (the 'Insolvency Regulation');
- Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements[3] (the 'Collateral Directive'); and

[1] The European Financial Markets Lawyers Group (EFMLG) was established in 1999 to discuss possible initiatives that would lead to increased harmonisation in the legal aspects and contractual practices of the EU financial markets following the introduction of the euro. The group is composed of in-house lawyers of those EU-based credit institutions that are most active in the European financial markets. The members of the group, who are listed in the Annex to this letter, are selected exclusively on the basis of their personal experience and do not represent their institutions.

[2] OJ L 160, 30.06.2000, p. 1.

- Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions[4] (the 'Banks Winding-up Directive').

To resolve these uncertainties, we believe there is a pressing need to clarify Community law on the scope of protection for insolvency close-out netting arrangements.

The main reason for clarification is deep uncertainty as to whether the set-off protection in Article 6 of the Insolvency Regulation encompasses close-out netting. As a result, in many EU Member States it is unclear whether close-out netting arrangements in insolvency proceedings concerning non-financial counterparties are enforceable. Financial market participants and regulators consider it essential to have a high degree of legal certainty on the enforceability of contractual set-off and netting agreements in the event of a default by a counterparty. Their concern for certainty is shared by both the Community and the Basel Committee on Banking Supervision in view of the implications of the enforceability of set-off and netting agreements for the prudential supervision of credit institutions and the stability of the international financial system. Ensuring the certainty of enforceability would guarantee the necessary level of legal protection for key financial instruments, which play a vital role in modern financial markets. This would make financial transactions and the legitimate expectations of parties more certain in an area where any doubt creates severe risk of systemic damage and impaired market efficiency.

The legal protection for close-out netting provisions in the Collateral Directive is not sufficient to overcome the uncertainty, since the Collateral Directive applies only to close-out netting provisions in a financial collateral arrangement, or an arrangement of which a financial collateral arrangement forms part. In addition, Member States may opt to exclude from the scope of the Collateral Directive financial collateral arrangements in which the collateral taker and the collateral provider do not both belong to one of the listed categories of financial institutions and public authorities. This potential exclusion could further weaken the protection for close-out netting provisions in financial collateral arrangements with non-financial counterparties.

Clarification is also required because the Community *acquis* on the enforceability of bilateral set-off and netting agreements is incoherent due to the divergent approaches taken by the Community legislator to overcoming legal uncertainties on their enforceability. The main legal risks affecting the enforceability of set-off and netting agreements arise under the insolvency

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[3] OJ L 168, 27.06.2002, p. 43.

[4] OJ L 125, 5.5.2001, p. 15.

law applicable to a defaulting counterparty, rather than the governing law of the contract. The Collateral Directive correctly sought to overcome these risks by requiring Member States to ensure the enforceability of close-out netting provisions in financial collateral arrangements. By contrast, the Insolvency Regulation and the Banks Winding-up Directive sought to overcome the same risks by creating special conflict-of-law rules designed to circumvent the insolvency law applicable to the defaulting counterparty by ensuring that the governing law of the contract would determine the enforceability of set-off and netting agreements. We consider that this conflict-of-law approach is unsatisfactory without general legislative recognition of such agreements. Indeed, this approach can create surprising results that are contrary to the expectations of parties, thus replacing one form of legal uncertainty with another. We consider that the Collateral Directive's approach to the enforceability of insolvency set-off and netting agreements is conceptually preferable to the approach in the Insolvency Regulation and the Banks Winding-up Directive.

Ideally, we would support an EU legal act on close-out netting. However, we recognise that this proposal might not be feasible at present in view of the Commission's legislative agenda following the Financial Services Action Plan (FSAP). We note, however, that an opportunity to address this issue might arise during a possible review of the conflict-of-law provisions in Article 9 of the Collateral Directive, in the light of the Hague Convention of 13 December 2002 on the law applicable to certain rights in respect of securities held with an intermediary. We would urge the Commission to take advantage of such a review process, which will involve discussions in the European Parliament and the EU Council, to also amend and expand the Collateral Directive's close-out netting provisions.

Without prejudice to other possible legislative solutions, including an EU legal act on close-out netting, we recommend that the definition of 'close-out netting provision' in Article 2(1)(n) of the Collateral Directive be amended as follows:

> '(n) 'close-out netting provision' means a provision of a**n** []arrangement, **whether** or **not such** an arrangement **forms part** of []a financial collateral arrangement[], or, in the absence of any such provision, any statutory rule by which, on the occurrence of an enforcement event, whether through the operation of netting or set-off or otherwise: (i) the obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value, or are terminated and replaced by an obligation to pay such an amount; and/or (ii) an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party.'

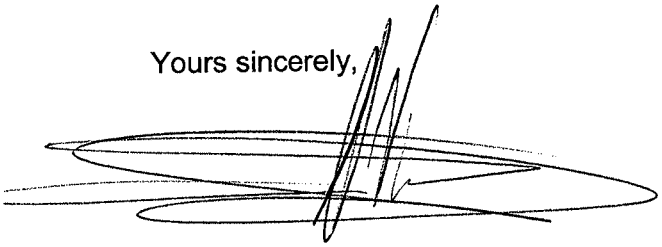
Also, consistent with this amendment, we recommend that the fourteenth recital of the Collateral Directive be amended as follows:

> 'The enforceability of bilateral close-out netting should be protected, not only as an enforcement mechanism for title transfer financial collateral arrangements including repurchase agreements but more widely[]. Sound risk management practices commonly used in the financial markets should be protected by enabling participants to manage and reduce their credit exposures arising from all kinds of financial transactions on a net basis, where the credit exposure is calculated by combining the estimated current exposures under all outstanding transactions with a counterparty, setting off reciprocal items to produce a single aggregated amount that is compared with the current value of **any[**]collateral **provided**.'

We have consulted the International Swaps and Derivatives Association (ISDA), the London Financial Markets Law Committee (FMLC) and the New York Foreign Exchange Committee's Financial Market Lawyers Group (FMLG) on the attached report, as the issues it raises are of interest to market participants and regulators in both the EU and the broader global financial markets.

We would be happy to give you any more information or help, if needed.

Yours sincerely,



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Annex

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Mr. Thomas, Martin	Financial Markets Law Committee
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