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Mr. David Wright
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Financial Services Policy and Financial Markets
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Directive 2002/47/EC on Financial Collateral Arrangements – Proposal for a European Netting Directive

Dear Mr Wright,

We are writing on behalf of the European Financial Markets Lawyers Group (EFMLG)¹ and the International Swaps and Derivatives Association, Inc (ISDA)² to express our concern over the Commission's tentative decision not to take on to its agenda the industry's proposals for a substantial overhaul of the Directive 2002/47/EC on Financial Collateral Arrangements³ (the "Financial Collateral Directive").

In January 2006, the Commission invited the industry to contribute to the evaluation of the Financial Collateral Directive and to make proposals for its further development. At that time, the EFMLG and ISDA welcomed this initiative and contributed to the industry survey by

¹ The European Financial Markets Lawyers Group (EFMLG) is a group of senior legal experts from the EU banking sector dedicated to analysing and undertaking initiatives intended to foster the harmonisation of laws and market practices and facilitate the integration of financial markets in Europe following the introduction of the euro. The members of the Group are selected, on the basis of their personal experience, amongst lawyers of those credit institutions based in the EU which are most active in the European financial markets, namely the banks of the Euribor and Eonia panels. More information about the EFMLG and its activities is available on its website at www.efmlg.org.

² The International Swaps and Derivatives Association, Inc (ISDA) is the largest global financial trade association by number of member firms representing leading participants in the privately negotiated derivatives industry. ISDA was chartered in 1985 and today has over 825 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the credit and market risks inherent in their core economic activities. More information about ISDA and its activities is available on its website at www.isda.org.

³ Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (OJ L168, 27.6.2002, p.43).

sharing their views on the questions raised by the Commission⁴. Members of the EFMLG and ISDA have had the opportunity to discuss, among ourselves and also informally with the Commission, the industry's position on and potential proposals in relation to the Commission's Evaluation Report, which was finally published in December 2006.

We have now learned that the Commission is preparing a proposal for a new Directive amending jointly the Financial Collateral Directive and the Directive 98/26/EC on settlement finality⁵ (the "Finality Directive"), but revising only some of the provisions identified in the Evaluation Report.

We fully support the work that the Commission is undertaking, especially as far as the extension of eligible collateral to certain bank receivables and the further harmonisation of the *acquis communautaire* on conflict of laws are concerned. We also understand that the Commission is driven by the concern that further amendments might be premature and require more comprehensive and thorough analysis. However, as summarised in Annex 1 to this letter, it is our view that there is certainly room for further progress, in particular where the personal and material scope of the Financial Collateral Directive and the protection of close-out netting are concerned.

As outlined in previous surveys and reports⁶, both the industry and its regulators consider it essential to have a high degree of legal certainty regarding the enforceability of contractual close-out netting arrangements. Furthermore, the Directive 2006/48/EC⁷ (the "Banking Directive") explicitly requires that credit institutions when using contractual netting arrangements – as well as competent authorities – must be satisfied that netting is legally valid and enforceable under the laws of each relevant jurisdiction⁸. This provision highlights the Community's concern for legal certainty in view of its implications for the prudential supervision of credit institutions and the stability of the financial system and at the same time the need for the Community to take action to enable its banks to comply with such requirements.

We do believe that it is feasible to provide legal certainty by enacting a new Netting Directive. The main content of such an instrument should, in our view, be as outlined in Annex 2 to this letter. It would also help to recast and harmonise the *acquis communautaire* on netting especially as far as the conflict of law rules are concerned.

If after considering this letter, the Commission decides not to initiate a specific Netting Directive along the lines proposed, we believe that the provisions of the Financial Collateral Directive dealing with close-out netting should be revised and improved. In either case, the principal purposes of such measures would be (i) to promote convergence of the legal frameworks for close-out netting in the various Member States and (ii) to provide guidance to newer Member States and potential future Member States as to the core principles that should underlie a sound regime for close-out netting. This would have the following benefits:

⁴ See the EFMLG letter entitled 'Response to the Commission Questionnaire regarding the Transposition of Directive 2002/47/EC on Financial Collateral Arrangements' of 7 April 2006, the ISDA letters entitled 'Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements' of 3 April 2006 and 15 September 2006 as well as the ISDA's report entitled 'Collateral Arrangements in the European Financial Market – The Need for National Law Reform' of November 1999 (revised version of March 2000).

⁵ Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems (OJ L166, 11.6.1998, p.45).

⁶ See, for example, the EFMLG report entitled 'Protection for Bilateral Insolvency Set-off and Netting Agreements under EC Law' of October 2004 and the ISDA memorandum entitled 'Memorandum on the Implementation of Netting Legislation – A Guide for Legislators and Other Policy-Makers' of March 2006, which provides guidance on the ISDA 2006 Model Netting Act (published in March 2006 and republished with minor revisions in October 2007).

⁷ Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (OJ L 177, 30.6.2006, p. 1).

⁸ See Annex III, Part 7 of the Banking Directive.

- enhancing legal certainty by creating greater uniformity of legal outcomes within the Community;
- helping to create a level playing field for all financial market participants in the Community; and
- lowering systemic risk within and improving the efficiency of the European financial markets.

We would be pleased to discuss our proposal further with you or your staff and to answer any questions you may have.

Yours sincerely,

Antonio Sáinz de Vicuña



Chairman
European Financial Markets
Lawyers Group

Robert G. Pickel



Executive Director and CEO
International Swaps and Derivatives
Association, Inc.

Annexes

Commission's Evaluation Report on the Financial Collateral Directive of 20th December 2006 – Proposal for a revision of the Financial Collateral Directive or for the adoption of a Netting Directive

We welcome the Commission's Evaluation Report on the Financial Collateral Directive and the conclusions reached therein. However, we encourage the Commission to reconsider at least the following points.

1. Personal Scope of Application:

The question of which entities may benefit from the Financial Collateral Directive is of crucial relevance. From a financial institutions perspective, carrying out business cross-border and vis-à-vis all types of counterparts including non-financial institutions and individuals, the personal scope of the Financial Collateral Directive should be as widely defined as possible. Whilst it is positive that only two Member States have used a full opt-out under Article 1(3) of the Financial Collateral Directive, it has to be noted that other Member States have chosen a personal scope which either provides for more nuanced limitations or for a wider application than foreseen by the Financial Collateral Directive. This state of diversity results in a continuous need for further due diligence to determine if, or under which conditions, a collateral transaction would profit from the new regime. We strongly encourage the Commission to contemplate removing any opt-out possibilities and to expand the personal scope of application to a wider range of entities (including, at least, entities other than consumers).

2. Material Scope of Application

We welcome the Commission's conclusion to consider the broadening of eligible collateral in order to cover 'credit claims'. However, the Commission should extend the scope beyond credit claims and include all receivables whether arising under a loan agreement or under any other contract (e.g., a purchase or service agreement). This would be in line with Basel II and the Banking Directive which, if certain requirements are met, recognise the assignment of receivables as eligible credit risk mitigation. The Commission should also aim at enhancing the existing scope of eligible collateral described by the terms 'financial instruments'. The Commission should especially address some of the legal issues that have been identified when implementing the Financial Collateral Directive, e.g., the inclusion of debt obligations and shares 'not tradable in the capital market'. We suggest that in the light of these experiences, the Commission should assess whether the beneficial effect of the Financial Collateral Directive could be generally extended to other types of assets commonly used in the financial markets.

3. Rating Related Top-up Collateral

Although the Financial Collateral Directive permits and offers legal certainty to mark-to-market and substitution mechanisms, it fails to deal with the common scenario in which top-up is required due to a deterioration of the credit rating of the collateral provider. We realise that this omission was based on the reluctance to propose measures conflicting with insolvency laws of some Member States which discourage

provisions under which a creditor's position is improved as a result of an insolvency-related event or a context of deteriorating credit-worthiness. We believe, however, that it is preferable to address this situation and offer legal certainty to all situations where top-up is linked to an objective trigger which cannot lead to a discretionary misuse by the parties.

4. Protection of Close-out netting arrangements

The protection of close-out netting arrangements is of paramount importance to financial market participants. It reduces credit risk, and hence allows an increase in the credit exposures that institutions are able to accept. In conjunction with this, the amount of capital legally required for credit institutions to cover their credit exposures could be reduced. Netting can also contribute to reducing settlement and liquidity risk and, as a consequence, systemic risk. We therefore appreciate that the Commission is willing to further explore the possibility of improving the existing framework for netting. However, we would appreciate if the Commission would not hesitate to swiftly start this exercise and involve the financial industry at the earliest stage possible. We attach in Annex 2 a first outline of what could be the content of a draft proposal for a directive on close-out netting arrangements (the "Netting Directive"), which, however, is to be understood as a feasibility study only.

**Outline of a draft proposal for a Directive on Close-Out Netting
Arrangements
(the 'Netting Directive')**

Subject matter and scope

- The Netting Directive should apply to bilateral close-out netting arrangements and the transactions entered into thereunder.
- To the extent not covered by the Finality Directive, it should also cover multilateral close-out netting arrangements, e.g., those provided for by multilateral trading facilities.
- The coverage of close-out netting arrangements should be as broad as possible and include close-out netting arrangements where one or both parties are natural persons. For the sake of legal certainty and a level playing field in the internal market, there should be no elective derogations ('opt-outs') from the scope of persons covered by the Netting Directive.
- The covered transactions should be defined in a separate Annex to the Netting Directive. The definition should be broad in order to cover all types of transactions irrespective of the type of underlying and of whether the relevant transaction is exchange traded or concluded 'over the counter' or whether cash settlement or physical settlement is agreed. The definition should also be broad enough to cover foreseeable future market developments.
- For avoidance of doubt, the Annex to the Netting Directive should not refer to Section C of Annex I of the Directive 2004/39/EC on markets in financial instruments¹, because the terms introduced therein serve different purposes and also do not cover the full range of financial market exposures that are currently subject to close-out netting arrangements.
- It should be clarified that the inclusion in any close-out netting arrangement of any transaction not listed in the Annex to the Netting Directive should not affect the application of the Netting Directive.
- The Netting Directive should clarify in relation to a multi-branch entity (which would typically be a bank) that the enforceability of close-out netting against the multi-branch entity in the jurisdiction of the main proceedings (in relation to a non-bank company) or home country proceedings (in relation to a bank or insurance undertaking) should not be affected by the laws of any jurisdiction where a branch of that entity might

¹ Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (OJ L145, 30.4.2004, p.1).

be located (whether that branch is located in a Member State or otherwise).

Definitions

- Some of the definitions used under the Netting Directive could be borrowed from the Financial Collateral Directive.
- Examples are the terms 'winding-up proceedings' and 'reorganisation measures', which for sake of consistency of the *acquis communautaire* should have the same meaning.
- New definitions are, however, necessary.
- Examples are the terms 'close-out event' and 'close-out netting arrangement', which in the context of netting have to be construed differently.

Formal requirements

- The Netting Directive should ensure that the validity and enforceability or the admissibility in evidence of a close-out netting arrangement or transactions governed by it are not dependent on the performance of any formal act.
- Formal acts include, amongst other requirements, registration, notarisation or the provision of a 'certain date'.
- The Netting Directive should be applicable to all close-out netting arrangements and transactions, which can be evidenced in writing or in a legally equivalent manner. As far as transactions are concerned, 'legally equivalent' should also cover trades that have been concluded orally and that are evidenced by tape recordings or statement of a witness only or otherwise and transactions concluded via electronic platforms or systems.

Enforceability of close-out netting arrangements

- The Netting Directive should ensure that, on the occurrence of a close-out event, the close-out netting arrangement comes into effect and is enforceable as provided in the terms agreed therein.
- The Netting Directive should specify examples of events or actions that should not constitute a requirement for the enforceability of the close-out netting arrangement.
- Specified examples should include (i) prior notices of the intention to terminate and close-out: (ii) approvals of a court, public officer or other person and (iii) the determination of current values, costs or losses as of a prescribed date or point in time or in a prescribed manner.

- It should be ensured that close-out netting arrangements can take effect notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures or any purported assignment, attachment or other disposition of or in respect of the close-out netting arrangement.
- The Netting Directive should ensure that covered transactions are not void or voidable or otherwise unenforceable just by reason of a law relating to gaming or gambling.

Certain insolvency provisions disapplied

- The Netting Directive should ensure that any transfer of cash, financial instruments or commodities under the close-out netting arrangement or any transaction should not be declared invalid or void on the sole basis that the transfer was made on the day of the commencement of winding-up proceedings or reorganisation measures in a prescribed period prior to the commencement of such proceedings.
- It should also be provided that the operation of a close-out netting arrangement shall not be affected by any moratorium, stay, freeze or any decree or order with a similar effect made by any administrative or judicial authority or liquidator or similar official.

Conflict of laws

- The Netting Directive should ensure that all questions arising in relation to the enforceability of a close-out netting arrangement shall be governed solely by the substantive civil law chosen by the parties of the close-out netting arrangement.
- The relevant matters governed by such laws should be explicitly named, including (i) the legal nature of a close-out netting arrangement and (ii) the requirements and legal steps necessary to render a close-out netting arrangement and the transactions thereunder effective and enforceable.
- Once the Netting Directive provides for appropriate conflict of law rules applicable to all close-out netting arrangements, Article 25 of the Directive 2001/24/EC on the reorganisation and winding up of credit institutions² (the 'Winding-up Directive') could be deleted. If the Commission decides to maintain Article 25 of the Winding-up Directive, it should at least further clarify the term 'netting' as well as the aspects outlined above preferably by, to the extent possible, applying the same terminology and formulations as those intended for the Netting Directive.

² 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 (OJ L125, 5.5.2001, p.15).

- The Netting Directive should be formulated in a conclusive manner so as to avoid any possibility of conflicting application of the Rome I Regulation³, e.g. by referring to the principle of 'lex specialis'.

³ Regulation (EC) n° [...] /2008 of the European Parliament and of the Council of [...] on the law applicable to contractual obligations (Rome I) (not yet published in the OJ).