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- THE VICE-CHAIRMAN -

6 May 2021

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Dear Sir or Madam,

Re: Targeted Consultations on the Review of the Settlement Finality Directive and the Financial Collateral Directive

On 12 February 2021, the European Commission launched two targeted consultations on the review of the Directive 98/26/EC on settlement finality[1] (**SFD**) and the Directive 2002/47/EC on financial collateral arrangements[2] (**FCD**)[3].

[1] 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 L 166, 11.6.1998, p. 45–50).

The review of the SFD is based on Article 12a SFD, requiring the European Commission to evaluate by no later than 28 June 2021 how Member States apply the SFD to their domestic institutions which participate in payments and financial instruments settlements systems governed by the law of a third country and which provide financial collateral in connection with their participation in such systems. Article 12a SFD must be seen in connection with recital (7) of the SFD, which authorises Member States to extend the protection provided under the SFD to participants of third-country systems incorporated or organised in their territory. Some Member States, like Germany[4], have used this option.

Article 12a SFD has been introduced by Article 2(2) of Directive (EU) 2019/879[5] (**BRRD II**), which is part of the so-called Risk Reduction Package[6]. Recital (34) of the BRRD II indicates the global size and significance of some of the settlements systems governed by the laws of third countries and the "increased participation" of European institutions in such systems, which cannot be interpreted as anything other than a reference to the withdrawal of the United Kingdom from the European Union (the so-called "Brexit").

Although the mandate of Article 12a SFD is narrowly defined, the Commission decided to review the FCD at the same time.

Considering the close relationship between SFD and FCD and their partial overlap, e.g. in the area of the conflict of laws rules governing the proprietary rights in indirectly held book-entry securities (Article 9 SFD and Article 9 FCD), the members of the European Financial Market Lawyers Group (**EFMLG**)[7] welcome the European Commission's broad initiative, especially as the last fundamental review[8] of the FCD was carried out before the global financial crisis of 2008-2009 and the subsequent legislative response which reshaped the regulatory framework for financial institutions and market infrastructure not just in Europe.

We would like to take the opportunity to address some critical issues that should be considered when proposing amendments to the SFD and the FCD.

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2 Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (OJ L 168, 27.6.2002, p. 43–50).

3 Link to consultation documents: https://ec.europa.eu/info/consultations/finance-2021-financial-collateral-review_en, visited 29 March 2021.

4 Cf. Section 1 para. (16) sent. 2 of the German Banking Act (*Kreditwesengesetz – KWG*).

5 Directive (EU) 2019/879 of the European Parliament and of the Council of 20 May 2019 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC PE/48/2019/REV/1 (OJ L 150, 7.6.2019, p. 296–344).

6 The Risk Reduction Package was published on 7 June 2019; it amends the Directive 2013/36/EU (CRD), the Regulation (EU) No 575/2013 (CRR), the Directive 2014/59/EU (BRRD) and the Regulation (EU) No 806/2014 (SRMR).

7 The European Financial Markets Lawyers Group is a group of senior legal experts from the EU banking sector dedicated to undertaking analyses and initiatives intended to foster the harmonization of laws and market practices and facilitate the integration of financial markets in Europe. The Group is hosted by the European Central Bank. More information about the EFMLG and its activities is available on its website at www.efmlg.org.

8 Cf. Report from the Commission to the European Parliament and the Council on the evaluation of the Financial Collateral Arrangements Directive (2002/47/EC) of 20 December 2006 (COM(2006) 833 final) (**FCD Evaluation Report 2006**).

1. Financial Collateral Directive

a) Directive vs. Regulation

In order to ensure full application in all Member States and to create a uniform European cross-border framework, the FCD should be "upgraded" to become a regulation, which is directly applicable in all Member States (Article 289(1) TFEU).

The provision of legal certainty through regulation in areas of substantial bankruptcy law is not without precedent. The last example was Regulation (EU) 2019/834[9] (**EMIR Refit**), which introduced a new Article 39(11) of Regulation (EU) No 648/2012 (**EMIR**) on the recognition of the transfer and close-out of client positions in a clearing member's default.

b) Opt-out Provisions

In the course of the negotiations of the FCD, special attention was paid to the FCD's scope of application and on whether the protection provided under the FCD, e.g. against bankruptcy clawbacks, may conflict with the principle of equal treatment of creditors in bankruptcy (*par conditio creditorum*).

In order to address the concerns of some Member States, three opt-out options have been introduced, authorising the Members States to reduce the personal scope of the FCD by excluding financial collateral arrangements entered into by non-financial corporates (Article 1(3) FCD), to exclude own shares and shares issued by affiliates from the scope of eligible collateral (Article 1(4)(b) FCD) or to decide to not recognise the realisation of financial collateral by appropriation (Article 4(3) FCD). Following the European Commission's report on the evaluation of the FCD of 20 December 2006 (**FCD Evaluation Report 2006**)[10], during which it was determined that none of the Members States has used the opt-out of the collateral taker's right of appropriation, Article 4(3) FCD has been deleted by Article 2(7)(c) of Directive 2009/44/EC. However, the first two opt-out options are still applicable.

As far as the protection of non-financial corporates (Article 1(3) FCD) is concerned, as further described in the FCD Evaluation Report 2006, at the time only one Member State decided to apply a full opt-out. Five Member States applied a partial opt-out by e.g. excluding only small and medium-sized entities (**SME**) or limiting the protection to certain financial obligations. The deletion of Article 1(3) FCD was discussed in the FCD Evaluation Report 2006. However, at the

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[9] Regulation (EU) 2019/834 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 648/2012 as regards the clearing obligation, the suspension of the clearing obligation, the reporting requirements, the risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty, the registration and supervision of trade repositories and the requirements for trade repositories PE/73/2019/REV/1 (OJ L 141, 28.5.2019, p. 42–63).

[10] Cf. footnote 8.

time, the European Commission was not prepared to re-open the above-mentioned discussion on the European level.

The fragmentation of national law caused by Article 1(3) FCD was discussed in the context of Directive (EU) 2019/1023 on preventive restructuring frameworks[11] (**PSFD**). Article 31(1) PSFD clarifies that the stay of individual enforcement actions in accordance with Article 6 PSFD should not impact on the safeguards provided under the national laws implementing the FCD. However, the discussion on the scope of protection provided under such national implementation led to a specific opt-in right in Article 7(6) PSFD for netting arrangements (i.e. the possibility to restrict a stay of individual enforcement action to the claim arising as a result of the netting), which because of the use of the opt-out pursuant to Article 1(3) FCD would not benefit from the protection under the FCD.

The removal of the two existing opt outs would enhance the European legislative financial framework, avoiding internal divergences among Member States and thus contributing to a simpler, safer and more robust European market either for local market participants or for third country firms willing to invest in the European Union.

c) Close-out Netting Arrangements

In its joint letter to the Commission of 14 April 2008 (**Joint Letter**)[12], the International Swaps and Derivatives Association, Inc. (**ISDA**) and the EFMLG reiterated their view that it is essential for both the industry and its regulators to have a high degree of legal certainty regarding the enforceability of contractual close-out netting arrangements. Articles 206 and 296 of Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms[13] (**CRR**) and Article 2(3) of the Commission Delegated Regulation (EU) 2016/2251 on regulatory technical standards for risk-mitigation techniques for OTC derivative contracts[14] (**Uncleared Margin RTS**) explicitly require that credit institutions, investment firms and non-financial corporates when using contractual netting arrangements must be satisfied that netting under their arrangements is legally valid and enforceable under the laws of each relevant jurisdiction.

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[11] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency) PE/93/2018/REV/1 (OJ L 172, 26.6.2019, p. 18–55)

[12] The letter is available at: http://www.efmlg.org/Docs/Documents/2008-04-14%20ISDA%20letter%20to%20EC%20on%20Directive%202002_47_EC%20on%20Financial%20Collateral%20Arrangements%20_%20Proposal%20for%20a%20European%20Netting%20Directive.pdf.

[13] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1–337).

[14] Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty C/2016/6329 (OJ L 340, 15.12.2016, p. 9–46)

The above-mentioned provisions highlight the Union's concern for legal certainty in view of its implications for the stability of the financial system. As can be seen from the Uncleared Margin RTS, which apply to all counterparties that intend to enter into uncleared OTC derivatives, following the global financial crisis of 2008-2009, ensuring legal certainty is no longer just about the prudentially supervised credit institutions and investment firms, but about all market participants who trade financial instruments and which use contractual netting arrangements in order to mitigate their counterparty default risk. The broad use of contractual netting arrangements by non-financial corporates has also been highlighted by the International Institute for the Unification of Private Law (UNIDROIT) when publishing its 2013 Principles on the Operation of Close-out Netting Provisions[15].

The EFMLG believes that it is feasible to provide the required legal certainty either by enacting a new regulation on close-out netting (**Netting Regulation**) or by further developing the FCD. The main content of a Netting Regulation has been outlined in an annex to the Joint Letter. The annex could, however, also be used as guidance for a revision of the FCD which would include, amongst other modifications (see also below), changes to the subject matter and scope (Article 1(1) FCD) and the terms "close-out netting provision" (Article 2(1)(n) FCD) and "enforcement event" (Article 2(1)(l) FCD).

Due to the great increase in the clearing volumes of derivatives in Central Counterparties (**CCP**) since EMIR and its principal to principal clearing model come into effect, another field for adding legal certainty would be the clarification, at FCD level, that client clearing agreements (e.g. those developed by ISDA to cater for principal-to-principal client clearing) benefit from “close-out netting provisions” and that a single netting set can include various sub-netting sets (e.g. a single ISDA including annexes for client clearing trades and pure OTC trades).

d) Personal Scope

The broadening of the personal scope of application has been discussed in the FCD Evaluation Report 2006. At the time, a majority of ten Member States had widened the scope to cover also entities not mentioned in Article 1(2) FCD, which may be viewed as a strong indication of a possible need for adjustment.

It is not justified to exempt private individuals from the scope of application. It cannot be the purpose of the FCD to protect retail clients from entering into certain transactions (**SFT**) through depriving them of the safeguards and benefits (e.g. less associated costs in the provision of financial guaranties) provided under the FCD.

The list of eligible collateral taker and the collateral provider set out in Article 1(2) FCD should be amended to also cover:

- Re-insurance companies;

[15] The principles are available at: https://www.unidroit.org/english/principles/netting/netting-principles2013-e.pdf

- Investment firms regulated under the Directive (EU) 2019/2034 on the prudential supervision of investment firms[16] (**IFD**);
- Central securities depository (**CSD**) regulated under the Regulation (EU) No 909/2014 on central securities depositories[17] (**CSDR**);
- Alternative investment funds (AIFs). Although not explicitly mentioned in the consultation, there are also good arguments to extend the personal scope to AIFs and their management companies, which are subject to a similar supervisory regime as undertakings for collective investment in transferable securities (UCITS), which were already regulated entities in 2002 at the time the FCD came into force, and which are covered by Article 1(2)(c)(v) FCD. However, as stated in the consultation, the scope of the FCD has to be considered carefully, since the removal of national safeguards to the enforcement of financial collateral arrangements could contribute to moral hazard. At the same time, to achieve the FCD's objective of avoiding systemic risk, the scope of the FCD should cover systemically important collateral takers and providers. Thus, regarding AIFs it should be assessed whether their legal and supervisory regime should merit the same legal treatment for the purpose of this Directive as credit institutions, UCITS and other financial institutions.
- Crypto asset service providers: although the inclusion of this category could be seen as premature considering MiCA is still under discussion, due to their potential important role in the near future, the inclusion of this category of providers should be assessed. For this reason, we suggest the European Commission to take the necessary steps for the coordination between both pieces of legislation, for the final inclusion of these providers within the personal scope of the Directive.

It should also be clarified that the collateral provider or the non-defaulting party (in case of a Netting Regulation or FCD which protects all close-out netting arrangements) may also be established or domiciled outside the Union.

Further, the references to outdated directives and regulations used in Article 1(2) FCD should be updated.

e) **Financial Collateral**

The scope of financial collateral should be broadened. The following assets should be added to Article 1(4) FCD

[16] Directive (EU) 2019/2034 of the European Parliament and of the Council of 27 November 2019 on the prudential supervision of investment firms and amending Directives 2002/87/EC, 2009/65/EC, 2011/61/EU, 2013/36/EU, 2014/59/EU and 2014/65/EU PE/79/2019/REV/1 (OJ L 314, 5.12.2019, p. 64–114).

[17] Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 (OJ L 257, 28.8.2014, p. 1–72).

- "Close-out-amounts" determined in accordance with a "close-out netting provision"; the inclusion would support netting under cross product netting arrangements (including "master master agreements" and "bridges").
- Claims under "guarantees" or similar credit protection; the inclusion would support netting arrangements that include exposure of multiple counterparties (e.g. entities of the same group, especially which have provided each other guarantees).
- Crypto assets[18].
- The term "financial instruments" (Article 2(1)(e) FCD) should have the meaning assigned to it in Article 4(1) point (15) MiFID II and Section C of Annex I so that it would also cover derivatives and emission allowances and, going forward, crypto assets that resemble financial instruments.
- The term "credit claims" (Article 2(1)(o) FCD) should include loans granted by "financial institutions whether located in the Union or not".

f) Reorganisation Measures

The term "reorganisation measures" (Article 2(1)(o) FCD) could be clarified by adding references to Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms[19] (**BRRD**), the Regulation (EU) No 806/2014[20] (**SRMR**) and the PSFD.

g) Conflict of Laws

The need for a revision of the conflict of laws rule set out in Article 9 FCD has already been discussed in the FCD Evaluation Report 2006. Like Article 4(1) of the 2006 Hague Securities Convention[21], Article 9 FCD is based on the so-called "place of the relevant intermediary

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[18] While the legal and regulatory status of crypto assets in currently being assessed in Europe and the United States, the addition will make sense in respect of those crypto assets that will be susceptible of being used as collateral, presumably those bear a resemblance to securities (next bullet point) and the "asset-referenced" and "electronic money" tokens defined by the draft markets in crypto asset regulation (**MiCA**). Due to the initial stage of this regulatory process it is a matter that needs to be closely followed to assess whether their addition to Article 1(4) FCD still makes sense when MiCA is enacted.

[19] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ L 173, 12.6.2014, p. 190–348).

[20] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 (OJ L 225, 30.7.2014, p. 1–90).

[21] Hague Conference on Private International Law (HCCH), Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary of 5 July 2006, available at: https://www.hcch.net/en/instruments/conventions/full-text/?cid=72.

approach" (**PRIMA**). It provides that any question with respect to book-entry securities collateral shall be governed by the law of the country in which the relevant account is maintained.

Considering the inconsistent national implementation by the Member States, the Commission concluded that Article 9 FCD (as well as Article 9 SFD and Article 24 of the Directive 2001/24/EC on the reorganisation and winding up of credit institutions[22] (**Winding-up Directive**)) should be amended to improve the legal certainty within the Union by specifying the criteria for determining the relevant location where the account is "maintained"[23]. The Commission's proposal to introduce a clear and unique rule for determining the location of the relevant account has also been supported by the European Central Bank (**ECB**)[24]. As confirmed by the Commissions Communication of 12 March 2018[25] (**2018 Communication**) and the Commission Staff Working Document of 28 March 2018[26] (**2018 Evaluation**), the current fragmentation in the national conflict of laws regimes is still an issue[27]. However, the Commission decided not to take any action, but to continue its monitoring of the developments in this area and to assess how national interpretations and market practices evolve.

The EFMLG is concerned about the lack of activity in this important area. Legal certainty as to the law applicable to indirectly held book-entry securities and, in the near future to crypto assets, is of critical importance for the stability of the financial systems, which otherwise may face considerable systemic risks.

2. Settlement Finality Directive

a) Directive vs. Regulation

In order to ensure full application in all Member States, the SFD should be transformed into a regulation, which is directly applicable in all Member States.

b) Inclusion Mechanism

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[22] 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 L 125, 5.5.2001, p. 15–23).

[23] See page 11 of the FCD Evaluation Report 2006.

[24] ECB, Opinion (CON/2005/7) of 17 March 2005, note 6.

[25] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on the applicable law to the proprietary effects of transactions in securities of 12 March 2018, COM(2018) 89 final.

[26] Commission Staff Working Document, Impact Assessment, accompanying the documents (i) Proposal for a Regulation of the European Parliament and of the Council on the law applicable to the third-party effects of the assignment of claims (COM(2018) 96 final) and (ii) Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on the applicable law to the proprietary effects of transactions in securities (COM(2018) 89 final).

[27] See page 125 of the 2018 Evaluation and the summary of responses to Question 20 on page 105 of the 2018 Evaluation.

The inclusion mechanism set out in in Articles 2(a) and Article 10(1) sent. 1 SFD should be reconsidered. The SFD should apply automatically to all systems established in the Union, without being specified as such by the relevant Member State.

This should apply at least to those systems operated by a CSD or a CCP authorised in accordance with Article 16 CSDR or Article 14 EMIR. The designation of the system in accordance with Article 2(a) SFD should not be a precondition for operating the system (see Article 39(1) CSDR and Article 17(4) EMIR).

c) Third-country Systems

The safeguards provided under the SFD should apply to

(i) all participants established in the Union and all financial collateral provided by such participants, irrespective of whether the system is governed by the laws of a Member State or a third country and

(ii) all participants, whether located in the Union or not, that participate in a system established in the Union, and all financial collateral provided by such participants.

This should apply at least to those third-country systems that have been recognised by the Union in accordance with a procedure that ensures equivalence in legal certainty provided by the laws governing the third country. The recognition procedure for third-country systems, if any, could be aligned to the procedure set out in Article 25 et seq. EMIR.

d) Participants

The list of eligible participants defined in Article 2(f) SFD and by the term "institution" in Article 2(b) SFD should be amended to also cover:

- Investment firms regulated under the IFD;
- CSDs regulated under the CSDR.

Further, the references to outdated directives and regulations used in Article 2(b) SFD should be updated. The reference to the "Community" should be replaced with a reference to the "Union".

e) Securities vs. Financial Instruments

The term "securities" introduced by Article 2(h) SFD should be replaced with "financial instrument", wherever it appears in the text of the SFD.

Article 2(a) second indent SFD should be deleted.

f) Insolvency Proceedings

The definition of "insolvency proceeding" in Article 2(j) SFD should be aligned to the terms "winding-up proceedings" and "reorganisation measures" used in Article 2(1)(j) and (k) FCD.

g) Conflict of Laws

The conflict of laws rule set out in Article 9 SFD (and Article 24 Winding-up Directive) should be aligned to Article 9 FCD. As discussed above, we support the Commission's proposal to introduce a clear and unique rule for determining the location of the relevant register, account or centralised deposit system (including for the location of crypto assets).

The Commission should also consider, whether the wording "legally recorded" used in Article 9(2) SFD is clear enough to be implemented and construed consistently by all Member States. In order to support all legal concepts applied to the proprietary aspects of rights in indirectly held book-entry securities, we would support a mere functional approach and delete the word "legally".

The Commission should also introduce a provision (as in Article 9(1) sent. 2 FCD) which excludes *renvoi*. ("*The reference to the law of the Member State is a reference to its domestic law, disregarding any rule under which, in deciding the relevant question, reference should be made to the law of another country*").

Yours sincerely,

Fernando Conlledo

Vice-Chairman