



EUROPEAN CENTRAL BANK

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DIRECTORATE GENERAL – LEGAL SERVICES

5 November 1999

**MINUTES OF THE 2ND MEETING OF THE
EUROPEAN FINANCIAL MARKET LAWYERS GROUP**

on 11 October 1999

PARTICIPANTS: The list of attendants is attached (see Annex 1).

1. Introduction and approval of agenda

The second meeting of the European Financial Market Lawyers Group (EFMLG), initiated by the European Central Bank (“the ECB”), was held on 11 October 1999 at the premises of the ECB in Frankfurt, Germany.

The Chairman, Mr Antonio Sáinz de Vicuña, welcomed the participants, noting that the high degree of attendance showed the on-going interest of legal experts in the topics that had been identified at the first meeting.

The Chairman thanked those members of the EFMLG who, as rapporteurs for one of the issues to be further pursued after the first meeting, had made considerable efforts to prepare the documents which serve as basis for the discussions and the work to be undertaken by the EFMLG.

The EFMLG took note of parallel efforts that are currently undertaken by other groups such as the ISDA Collateral Law Reform Group and the Giovannini Group. In addition, a short report was given on the prospective EU Directive on the cross-border use of collateral. In this context, the EFMLG felt that it may be useful to give input to the preparatory work of the EU Commission.

The Chairman then introduced Ms Joyce Hansen, Deputy General Counsel of the Federal Reserve Bank, New York, in her capacity as Secretary to the Financial Market Lawyers Group (FMLG) of the Federal Reserve Bank of New York, and invited her to inform the EFMLG members of the past and present work of the FMLG.

2. Presentation of the FMLG and its current work programme

Ms Joyce Hansen gave a presentation of the Financial Market Lawyers Group of the Federal Reserve Bank in New York. The FMLG comprises in-house lawyers of US and non-US banks and meets on a regular basis in order to pursue a number of defined projects. Projects undertaken so far include legal support to the Foreign Exchange Committee of the Federal Reserve Bank by preparing legal documentation, which subsequently has set market standards in the US. Moreover, a collateral annex to these agreements has been drafted with the intention to establish a bridge to the ISDA Collateral Annex. The FMLG is also dealing with matters related to netting, in particular by providing legal opinions (including annual updates). Moreover, the FMLG was involved in the drafting of the Bond Market Association's Cross-Product Netting Agreement and gave advice to the UNCITRAL Convention on Receivables.

Ms Hansen also reported on the current FMLG project on force majeure, stating that it emerged in the financial crisis in south east Asia that the current master agreements might not be wholly appropriate for emerging markets, in particular as regards the differing waiting periods and the transfer of obligations to another office. The FMLG (together with ISDA) has proposed uniform amendments to both its own foreign exchange master agreements and the ISDA agreement. Remaining questions are the discrimination between on- and off-shore banks and the treatment of changes in currency regulations, where no consensus has been reached so far.

3. Legal update on pledges in the EU

The topic was presented by Mr Laurie Adams, as rapporteur, and Mr Ian Jameson.

It was stated that the purpose of this work is to scrutinise one of the main areas of concern with respect to legal difficulties of cross border use of collateral on a European-wide basis. To this end, the update on pledges (covering seven European jurisdictions so far), is focusing on pledge in a wider sense, i.e. on a wide range of possessory or non-possessory security interests, but so far excluding all kinds of transfer of title. The preliminary conclusions show that there is no uniform legal framework for pledges as the existing domestic structures derive from traditional, quite ancient legal techniques, traditionally relying on possession or control of tangible assets. In addition, frequently a notice of the establishment of pledge to the outside world is required and, in numerous cases, quite cumbersome procedures are involved.

It was also stated that, when looking at what the pledger really owns, a lack of transparency is becoming of major relevance, as pledges may involve lengthy chains of tiered custodians, something that is seen more and more frequently in the financial markets. This entails a clear understanding of subsequent questions such as how to perfect pledges and where the right of the pledger is actually located.

Practice shows that the inherent level of uncertainty poses problems in particular for the trading strategy of banks operating on a cross-border basis. Contrary to purely domestic situations where the legal background is usually known and the chosen law normally coincides with the applicable insolvency laws, this does not hold true for cross border situations, due to the *lex sitae* rule. The present situation might

create a tendency of banks to go for known structures and entails a need to ask for quite expensive legal opinions, depending on the counterparty/assets involved.

The EFMLG acknowledged that a first major step to solve these uncertainties has been undertaken in the Settlement Finality Directive, by reducing legal risks and providing certainty about such aspects as the abolition of the zero hour rule, the determination of the applicable law and the insulation from insolvency proceedings of assets provided as collateral within a settlement system. It was noted that there is a tendency amongst EU Member States to extend the application of the rules provided by this directive beyond the mere context of a payment or security settlement system, thus establishing a rule of general application.

The EFMLG took the view that it might be a viable option to remove certain of the existing problems through appropriate Community legislation, whereby it was acknowledged that, as far as lobbying for law reform is concerned, there are already a number of other groups dealing with these matters. The Group then focused on the possibility of introducing the findings of the EFMLG on the current project on pledge to the European Commission forum group for the preparation of a directive on the cross-border use of collateral.

As regards the alternative provided by “transfer of title” legal instruments, a number of problems inherent to pledges were felt to be less relevant. This holds especially true for specific formalities connected to pledges or the issue of re-hypothecation. Nevertheless, it was noted that there are also drawbacks to transfer of title solutions, like the risk of re-characterisation or the tax treatment. Also, from the point of view of a collateral provider, there might be higher risks in a transfer of title model as regards the insolvency of the collateral taker.

The Group concluded that within the framework of this exercise, there could be room to consider the assimilation of the features of pledge and transfer of title as far as possible, so that the only choice to be made by agents in the financial market would be to agree on the desired allocation of risks and the treatment tax issues, but to remove legal uncertainties as regards the validity and enforceability of collateral provided for cross border use. In addition, a common understanding of what is meant by “collateral” and “financial markets” might be necessary. Further thoughts are also needed on whether this project should be pursued by building on existing national structures or by pursuing a new type of legal instrument like a “security entitlement” in the meaning of Article 8 of the UCC.

As a first step, it was agreed to complete the legal update conducted by Mr Laurie Adams by adding chapters for the missing countries, to indicate references to “transfer of title” under the respective national jurisdictions and to include suggestions and comments on the already existing parts. In addition, a short paper to be prepared by Mr Laurie Adams and an additional member of the EFMLG (still to be nominated; Mr Bausch proposed a member of his staff) shall elaborate on a proposal for a possible framework for law reform.

4. Different legal concepts of debt

An issues paper dated 1 October, prepared by Mr Martin Thomas, was discussed, and the proposed questions set out in that paper were agreed upon, subject to certain small amendments, as being the appropriate questions to answer per EU jurisdiction in order to collect data from which to draw conclusions.

It was noted that there is no need to restrict the enquiry to debt denominated in euro, and that all debt active in the EU markets should be covered.

It was queried whether it would not also be fruitful to extend the scope of the enquiry to cover rules in each country relating to the type of debt that can be issued, such as rules relating to the maximum amount that may be borrowed, the identity of those parties eligible to issue debt, and what formalities are necessary. It was felt that, although these are points of interest, the focus of this exercise is to focus on the substantive internal features of securities, and try to avoid a comparative analysis of regulatory and investor protection regimes. In addition, it was felt that some of the existing questions are framed in such a way as to pick up on these matters, at least in part. It was, however, agreed that specific reference should be made to enquiring whether all countries have a distinction and, if so, what it is, between debt and equity, since this is a basic and fundamental point of consideration.

The group considered whether, as a secondary question, the issues of the tax treatment and of equity instruments might also be tackled.

It was also noted that a distinction might be necessary between national and international issuances of debt, whereas in the latter case a modification of the traditional understanding might be necessary because of the advent of European Monetary Union.

The group agreed to elaborate further on this topic on the basis of the stock taking exercise made through a revised questionnaire to be distributed to the group members.

5. Dematerialisation

The issue was introduced by the respective rapporteurs, Mr Philip Hanssens and Mr Martin Thomas. A presentation was given of the collection of the existing national legal framework already allowing for the issuance of dematerialised securities. It was noted that as of now, in almost all EU jurisdictions, there are rules allowing for dematerialised securities, although the scope of application as regards type of securities and issuers differs widely between jurisdictions.

There was a general discussion considering a paper dated 28 September 1999 on dematerialisation. It was noted that the topic of dematerialisation cannot be considered in isolation, since it relates intimately also to the methods by which securities are traded and how those trades are cleared and settled, and also to the ways in which securities are or can be used as collateral in financing operations. There was a general sentiment that the EFMLG may hope to make advances in the area of European harmonisation and integration, and that it was possible that the work product of the EFMLG on this topic eventually could

feed into the work recently commenced by the EU Commission on the subject of cross-border use of securities.

It was decided that the relevant fact-finding questions should also cover the nature of rights in dematerialised securities, and to draw comparisons with the nature of rights in (immobilised, where necessary) registered securities.

It was noted that in some segments of the market a strong desire and/or taste for physically-held securities remains, notwithstanding the increasing trend in the wholesale markets to favour whatever is most easy to trade.

The project of the Financial Law Panel (London) to propose a method of simplifying the legal structure of eurobonds in a manner that amounts to dematerialisation was also briefly discussed.

The Group felt that, in the context of multi-jurisdictional issuances, a harmonised structure might contribute to the unity of the market. Also, harmonisation might be enhanced through the tendency to reduce the number of existing security settlement systems in Europe. As regards the experience in the US market after the introduction of Article 8 UCC, apparently so far only the federal government makes extensive use of this dematerialised structure

It was agreed that a revised questionnaire will be sent to members of the Group encapsulating what questions are to be answered, so that the work of the Group can benefit from the input of its members in addition to the study conducted by ECB legal services.

6. Force majeure

A presentation was made by Mr Klaus Löber, as rapporteur on this issue.

When analysing the existing national situations, it showed clearly that in most countries legal concepts of force majeure do not differ very widely. Generally, in most Member States “force majeure” is defined by certain conditions such as unpredictability, the character of the obstacles being insurmountable and the prerequisite of absence of any default from the debtor’s side. Existing clauses in market agreements vary from clauses drafted in a quite general way to exhaustive listings of examples of what is deemed to be force majeure and, finally, a number of standard market agreements do not contain any definition of force majeure at all.

It was noted that a number of issues are particularly uncertain under force majeure concepts, e.g. situations like “strike” or “acts of government”. Nonetheless, a certain common understanding could be derived from the standing jurisprudence of the European Court of Justice, which in a number of cases distilled the common understanding of national legal practices in specific contexts.

The EFMLG felt that, as regards a possible harmonisation of force majeure clauses, in certain areas of the financial markets, very specific and differing scopes of protection might be wanted. In addition, force majeure clauses almost invariably touch the freedom of parties to negotiate the allocation of risks between them. Nevertheless, the issue might become relevant in a number of practical situations as currency control measures or civil unrest in emerging market countries might increase. From a European

perspective, a kind of commonly accepted and enforceable market standard might constitute additional certainty for financial transactions.

The group agreed to review the table on force majeure in the 15 EU jurisdictions on the basis of a questionnaire to be sent out and to provide examples of force majeure clauses in existing domestic and international standard market documentation.

7. Follow-up

It was agreed that the group members would review the documents distributed at the first meeting and provide additional input on the basis of the questionnaires mentioned above before **15 December 1999**. A third meeting of the European Financial Market Lawyers Group will, in all likelihood, be held during the first half of February 2000, prior to which the revised documentation will be distributed to the members to serve as a basis for further discussion.