



EUROPEAN COMMISSION

Directorate General Internal Market and Services

FINANCIAL SERVICES POLICY AND FINANCIAL MARKETS
Financial markets infrastructure

Brussels, 17 January 2011
DG MARKT/RW/OT/JC D(2011)

**DISCUSSION PAPER FOR THE 2nd MEETING OF THE
CLOSE-OUT NETTING
MEMBER STATES WORKING GROUP
26 January 2011
LEGISLATION ON CLOSE-OUT NETTING**

I. INTRODUCTION

G20, Basel, UNIDROIT and the EU

The G20 summit held in Seoul in November 2010 reaffirmed the G20's Toronto commitment to national-level implementation of the Basel Committee on Banking Supervision's cross-border resolution recommendations¹.

These recommendations call for the design and implementation of national systems whereby authorities have the powers and tools to restructure or resolve all types of financial institutions in crisis, including the authority to temporarily delay the immediate operation of contractual termination clauses, in order to complete a transfer of certain financial market contracts to another sound financial institution².

At the same time the recommendations encourage the use of enforceable netting arrangements, as a means of risk mitigation which reduces systemic risk and enhances the resiliency of critical financial or market functions during a crisis, or resolution of financial institutions³.

Reflecting these objectives, two work streams have been initiated in the EU.

First, the Commission plans to come forward with a "Legislative initiative on a framework for bank crisis management and resolution"⁴.

Second, it anticipates the adoption of another legal instrument to clarify the protection provided by close-out netting agreements including in the resolution of failing financial institutions (in pursuit of BCBS Recommendations 8 and 9). This instrument will therefore contribute to financial stability and help realise the significant, potential efficiency gains from strengthening the enforceability of netting across the EU.

Although at this stage two distinct instruments are envisaged, they could be adopted simultaneously. However, a decision on this and what precisely each measure will cover in respect of netting will reflect the results of further substantive work, including by the Working Group.

In pursuing the first work stream, the Commission launched on 6 January 2011 a consultation on technical details underpinning that framework, including regarding the treatment assigned to the netting arrangements of a failing bank in resolution. The deadline for comments on the "Working Document on Technical Details of a Possible EU Framework for Bank Recovery and Resolution" (hereafter referred to as "Crisis Management Consultation Paper")⁵ is 3 March 2011.

¹ See point 32 of the "Seoul Summit Document" available at <http://www.seoulsummit.kr/outcomes>.

² See Recommendation 9 of the Cross-border Bank Resolution Group of the Basel Committee on Banking Supervision (BCBS), March 2010, available at: <http://www.bis.org/publ/bcbs162.pdf?noframes=1> and page 39.

³ See Recommendation 8 and page 36 of the paper referred to in the footnote above.

⁴ Commission Work Programme 2011, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, COM(2010) 623 final.

⁵ Available at: http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm#consultation2011.

In order to progress the second work stream, the Commission will take on board the feedback to the above consultation in relation to netting in resolution. It will also consider the merits of a complementary netting consultation, which would extend beyond crisis management considerations.

In this context, it can also be noted that UNIDROIT will start to prepare an international convention or model law on the netting of financial instruments, focussing on its role as a mechanism applied by financial institutions in their daily financial market operations, in order to reduce their credit risk exposure. The first meeting of a study group will be convened in April 2011.⁶

17 December Working Group meeting

Discussion at the Working Group's first meeting of 17 December 2010 focussed on:

- The extent to which the legal framework for close-out netting ensures the recognition and enforceability of close-out netting ;
- The case for limiting the enforceability of close-out netting in a banking crisis so as to ensure financial stability.

It was recognised that the EU legal framework supporting close-out netting does not provide sufficient legal certainty regarding its general enforceability. Furthermore, the introduction of a crisis management framework to deal with failing banks raised a number of issues in relation to EU law⁷. These related inter alia to:

- The legal 'trigger' for a stay on the close-out netting rights of a failing bank's counterparties ('stay') to begin ;
- The length of such a stay ;
- Whether a stay should be imposed on the close-out netting rights of specific types of counterparties of a failing bank, notably central banks and central counterparties (CCPs) ;
- The desirability of a stay in the case of payment and securities settlement systems ;
- The scope for a resolution authority to 'cherry pick' different contracts under a netting agreement ;
- Definitions of key terms including netting in different EU legal instruments ;
- The need to determine the law applicable in the case of disputes arising from the introduction of a special resolution regime.

⁶ See the UNIDROIT Work Programme 2011-2013, approved on 1 December 2010.

⁷ Notably Directives 98/26 EC, 2001/24 and 2002/47 and Regulation 1346/2000.

As regards the general policy approach , two options were identified:

- The first option, the "top down approach", which was broadly adopted in the first discussion paper, would put the emphasis on promoting convergence of the legal frameworks for close out-netting in the various Member States and improving and/or harmonising the current EU framework⁸. This is important inter alia because of the high degree of legal certainty regarding the enforceability of close-out netting arrangements required by EU law implementing the Basel II Framework⁹. It also provides a coherent legal basis on which netting provisions tailored to the proposed bank resolution regime can be built ;
- The second option, the "bottom up approach", would start with the proposed bank resolution regime and then look at the extent to which the existing EU rules on close-out netting would need to be altered, updated or improved to make it work on a consistent basis across Europe. The Services of DG Internal Market and Services believe that this second approach is appropriate, given the urgent need to introduce its proposed crisis management framework and the risk of the complexities of the top down approach standing in the way of this objective. However, it is considered that certain general issues which extend beyond crisis management will have to be addressed in order to ensure that netting arrangements are dealt with appropriately both in crisis management, and when the markets are operating normally.

Which approach do Member States experts prefer?

Structure of paper

This paper first discusses close-out netting in the context of bank resolution (under the headings of stay, carve-outs from a stay and financial infrastructure). It includes relevant excerpts from the Commission's Working Document, including the questions included in it, whilst also covering a number of more detailed points, including those raised at the Working Group's 17 December meeting. The subsequent section covers conflict of law issues and key definitions, again in the context of bank resolution. Finally, an annex lists some of the key – including economic - papers on which the paper for the 17 December meeting was based, as requested by the chair.

Aim of meeting

The aim of the meeting is to discuss the questions set out in the text, together with any other issues that working group members raise, and thence next steps in this initiative.

⁸ See the report of the European Financial Markets Lawyers Group, "Protection for bilateral insolvency set-off and netting agreements under EC law", October 2004; www.efmlg.org/documents.htm.

⁹ See Part 7 of Annex III to 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) ('CRD') which requires, that the risk-reduction effect of contractual netting will only be recognised for the purposes of calculating banks' regulatory capital requirements if competent authorities are satisfied that the netting is legally valid and enforceable under the laws of each relevant jurisdiction.

II. STAY OR MORATORIUM OF CLOSE-OUT NETTING IN RESOLUTION OF FAILING BANK

Temporary suspension of close out netting¹⁰

The Services of DG Internal Market and Services consider that resolution authorities should have the power to impose a temporary suspension of all close out rights of any party under a netting arrangement with a failing credit institution that arise solely by reason of an action or anticipated action by the resolution authority (that is, use of resolution tools or resolution powers).

The suspension should last no longer than:

- (a) forty-eight hours after the time the suspension is notified ; or
 - (b) 5 p.m. on the business day following the day on which the suspension is notified
- (which ever is the longer period).

In order for a provision of this kind to be effective, it is necessary to identify a clear point from which the suspension would take effect. The Services of DG Internal Market and Services suggest that the suspension might begin from the point when it is notified, and for this purpose it would be treated as notified when the resolution authority makes public its decision.¹¹

The provision outlined above provides for a determinate point at which the suspension would expire. However, the Services of DG Internal Market and Services consider that it might also be appropriate to provide that a person should be able to exercise a right under a netting arrangement before that determinate point if that person receives notice from the resolution authority that the rights and liabilities covered by the netting arrangement will not be transferred to another entity.

The Services of DG Internal Market and Services consider that it is also necessary to include a provision about what rights may be exercised on the expiry of the suspension, and in this regard it is appropriate to distinguish between counterparties whose covered rights and liabilities have been transferred to a private sector purchaser or another entity such as a bridge bank, and those whose covered rights and liabilities remain with the residual, failed bank. On the expiry of the suspension:

- (a) if the rights and liabilities covered by a netting arrangement have been transferred to another entity ('the transferee'), a person may exercise all rights under that arrangement on the occurrence of any default event under the arrangement in relation to the transferee, as if the default event had occurred in relation to the failing credit institution, but the transfer and any related action by the resolution authority shall not be treated as a default event (and any term to that effect under a netting arrangement shall be void) ;
- (b) if the rights and liabilities covered by a netting arrangement remain with the relevant credit institution, a person may exercise all rights under that arrangement.

¹⁰ This section corresponds to Point G13 of the Crisis Management Consultation Paper; excerpt from pages 64-66.

¹¹ Section F2 of the Crisis Management Consultation Paper suggests a requirement for resolution authorities to make public a formal decision to put a bank or investment firm into resolution.

What are Member States' experts views on the suggested temporary suspension of close out netting rights, including the appropriate length of the suspension?

In addressing this, views on the nature of the trigger (including by reference to the experience of countries which already have bank resolution regimes) and on whether any classes of counterparty should be excluded eg central banks at least in relation to certain of their activities, are sought.

Carve-outs from transfer powers of resolution authorities

The provisions suggested in this section are intended to safeguard the interests of counterparties under netting agreements and in connection with security rights. The objective is to prevent resolution authorities from 'cherry picking' rights and liabilities under such protected arrangements. They must either all be transferred together, or not at all.

Partial transfers: safeguards for counterparties¹²

The Services of DG Internal Market and Services consider that the safeguards for counterparties under consideration should apply where:

- (a) a resolution authority transfers some but not all of the property, rights or liabilities of a credit institution to another entity ('a partial transfer') ; and
- (b) where a resolution authority uses ancillary powers (see section G6¹³ above) to cancel or modify the terms of a contract to which the credit institution under resolution is a party or to substitute a transferee as a party.

In the view of the Services of DG Internal Market and Services, the safeguards under consideration should apply to the following arrangements and the counterparties to such arrangements:

- (a) Security arrangements, under which a person has by way of security an actual or contingent interest in the property or rights that are subject to transfer, irrespective of whether that interest is secured by specific property or rights or by way of a floating charge or similar arrangement ;
- (b) Title transfer financial collateral arrangements under which collateral to secure or cover the performance of specified obligations is provided by a transfer of full ownership of assets from the collateral provider to the collateral taker, on terms providing for the collateral taker to transfer assets if those specified obligations are performed ;
- (c) Set off arrangements under which two or more claims or obligations owed between the bank and a counterparty can be set off against each other ;
- (d) Netting arrangements under which a number of claims or obligations can be converted into a single net claim, including close-out netting arrangements under which, on the occurrence of an enforcement event (however or wherever defined) the obligations of

¹² This section corresponds to Point H1 of the Crisis Management Consultation Paper; excerpt from pages 69-70.

¹³ Working Document, page 57.

the parties are accelerated so as to become immediately due or are terminated, and in either case are converted into or replaced by a single net claim ;

- (e) Structured finance arrangements, including securitisations and covered bonds, which involve the granting and holding of security by a party to the arrangement or a trustee, agent or nominee.

The Services of DG Internal Market and Services consider that the safeguards under consideration should apply to those arrangements irrespective of how they have been created and irrespective of the number of parties involved in the arrangements. In particular, they would apply regardless of whether the arrangements:

- are created by contract, trusts or other means, or arise automatically by operation of law ;
- arise under or are governed in whole or in part by the law of another jurisdiction.

The safeguards suggested in this Section would, however, be subject to the restrictions on the exercise of contractual rights to terminate, accelerate or otherwise close out suggested under G13 above (*Temporary stay on close-out netting rights*).

The Services of DG Internal Market and Services consider that it would also be necessary to specify that where a resolution authority purports to transfer all of the property, rights and liabilities of a credit institution to another entity, but the transfer is or may not be effective in relation to certain property because it is outside the European Union, or to certain rights or liabilities because they are under the law of a territory outside the European Union, that transfer should not be treated as a partial transfer and should not be subject to the suggested safeguards.

Do Member States' experts agree that the classes of arrangement suggested in this section should be subject to the suggested safeguards in the case of partial property transfers? Should any other market arrangements be included?

As a general approach, Section H of the Crisis Management Consultation Paper suggests a set of outcomes that Member States need to achieve (i.e. transfer of all or none of the property, rights and liabilities covered by the various kinds of market arrangements that are specified here). It does not prescribe how that should be done or, in particular, the consequences if a transfer contravenes these provisions. Is such further provision necessary?

Is further harmonisation of the definitions of the financial market arrangements covered under this section necessary for the safeguards to be effective?

The objective is to ensure appropriate protection ('no cherry picking') for legitimate financial market arrangements. Is there a risk that the necessary flexibility for resolution authorities could be undermined or frustrated, for example if non-related derivatives are included in a protected netting arrangement?

Appropriate protection for financial collateral, set-off and netting arrangements¹⁴

The Services of DG Internal Market and Services consider that the appropriate safeguard for title transfer financial collateral arrangements and set-off and netting arrangements should prevent:

- (a) the transfer of some, but not all, of the rights and liabilities that are protected under a title transfer financial collateral arrangement, a set-off arrangement or a netting arrangement between the credit institution and another person ; and
- (b) the modification or termination of rights and liabilities that are protected under such a title transfer financial collateral arrangement, a set-off arrangement or a netting arrangement through the use of ancillary powers.

For this purpose, the Services of DG Internal Market and Services consider that it would be necessary to specify that rights and liabilities are to be treated as protected under such an arrangement if the parties to the arrangement are entitled to set-off or net those rights and liabilities.

The Services of DG Internal Market and Services take the provisional view that Member States should be able to exclude from the protection suggested in this provision:

- retail rights and liabilities ;
- rights and liabilities that relate to arrangements entered into by the credit institution under resolution otherwise than in the course of its core banking business ;
- rights and liabilities that relate to subordinated debt issued by a party to the arrangement ;
- rights and liabilities which relate to a claim against the credit institution under resolution (including an award of damages or a claim under an indemnity) which arose in connection with the core banking business of that institution.

In this context:

- (a) "retail rights and liabilities" refer to:
 - rights and liabilities that relate to eligible deposits ;
 - liabilities owed to the credit institution under resolution by eligible depositors ;
- (b) "core banking business" means the activities specified in Annex 1 to Directive 2006/48/EC and activities of the credit institution which relate to financial instruments ;
- (c) "financial instruments" means transferable securities and money market instruments within the meaning of Article 4(18) and (19) of Directive 2004/39/EC and the following classes of instrument (irrespective of whether they are transferable securities) :
 - loans or other instruments creating or acknowledging debt ;
 - units in collective investment undertakings ;

¹⁴ This section corresponds to Point H2 of the Crisis Management Consultation Paper; excerpt from pages 71-72.

- any option, future, swap, forward, contract for differences or other derivative contract (including all instruments listed in points (4) to (10) of Section C of Annex 1 to Directive 2004/39/EC) ;
- any contract for the sale, purchase or delivery of transferable securities, currency, or commodities ; or
- any combination of such instruments.

Where a netting arrangement contains some provisions relating to rights or liabilities that are excluded from protection, the protection suggested in this section should apply to that arrangement only insofar as it contains provisions relating to rights or liabilities that are not excluded from that protection.

What are the Member States' experts views on the safeguards for title transfer financial collateral arrangements and set-off and netting arrangements?

Do you agree that certain retail rights and liabilities and rights and liabilities relating to subordinated debt should be excluded from the suggested safeguard?

Partial transfers: Protection of trading, clearing and settlement systems¹⁵

The Services of DG Internal Market and Services consider that where:

- (a) a resolution authority transfers some but not all of the property, rights or liabilities of a bank to another entity (using either sale of business tool, bridge bank tool or asset separation tool) ; or
- (b) a resolution authority uses ancillary powers to cancel or modify the terms of a contract to which the credit institution under resolution is a party or to substitute a transferee as a party ;

that transfer, cancellation or modification should not affect the operation of systems and rules of systems covered by the Settlement Finality Directive (Directive 98/26/EC). In particular, such a transfer, cancellation or modification may not revoke a transfer order in contravention of Article 5 of that Directive; and may not modify or negate the enforceability of transfer orders and netting as required by Articles 3 and 5 of that Directive; the use of funds, securities or credit facilities as required by Article 4 of that Directive; or protection of collateral security as required by Article 9 of that Directive.

Is express provision in relation to the protection of trading, clearing and settlement systems necessary, or are the provisions of the Settlement Finality Directive sufficient? If express provision is needed in this context, should the protections be drafted more broadly than those in the Settlement Finality Directive?

¹⁵ This section corresponds to Point H5 of the Crisis Management Consultation Paper; excerpt from page 73.

One general issue is whether references to insolvency proceedings etc in Directives such as the Settlement Finality Directive, need to be amended to refer to bank resolution.

In addition, it has been pointed out that the specific category of clearing systems presents a number of issues. For example, given that the purpose of the transfer of rights and liabilities to a bridge bank in resolution is to preserve the contracts of the failing credit institution, it could be argued that a transfer should cover the failing clearing bank's obligations within the clearing system. Moreover, the case for doing so would be reinforced should an increasing proportion of contracts be cleared through CCPs, in reflection of the Commission's EMIR Proposal¹⁶.

The financial stability-related benefit of doing so would be that positions would thus be transferred from a failing clearing bank to a solvent transferee. In consequence, the CCP would have a healthy bridge bank as a new clearing member and would not have to call a default and thus risk any resulting 'fire sale' losses. However, in considering this, the implications for the risks taken on by non clearing members in the chain leading up to the clearing member should be identified and weighed, by comparison with a framework in which CCPs are not subject to a stay.

Second, it has been noted that Article 70 of the EMIR Proposal purports to amend the Settlement Finality Directive in relation to interoperable collateral givers and takers by providing that *"Where a system operator has provided collateral security to another system operator in connection with an interoperable system, the rights of the providing system operator to that collateral security shall not be affected by insolvency proceedings against the receiving operator"*. On one interpretation, this provision would exclude system operators completely from the operation of any proceedings aimed at restoring the financial situation of a failing credit institution, including a special EU resolution regime. This is of course different than the solution proposed for a possible "Securities Law Directive" which requires Member States to introduce a special mechanism governing the distribution of the shortage in the event of an insufficient number of securities being held by an insolvent account provider¹⁷.

Given the increasing importance of CCPs within the financial system, how should they be treated in a possible EU netting instrument and, consistent with this, are amendments to other instruments required?

¹⁶ See the Commission Proposal for a Regulation on OTC derivatives, central counterparties and trade repositories, COM(2010) 484 final, which introduces mandatory CCP clearing for all standardised OTC derivatives contracts.

¹⁷ See Principle 10 of the Consultation Document of the Services of the Directorate-General Internal Market and Services on the legislation on legal certainty of securities holding and dispositions, available at: http://ec.europa.eu/internal_market/consultations/2010/securities_en.htm

III. CROSS-BORDER EFFECTIVENESS OF THE RESOLUTION REGIME

As suggested above, the netting agreement and the financial contracts it covers should form a bundle that is not to be dissociated. However, where a resolution authority transfers such a bundle to a bridge institution ("the transferee"), it is highly likely that either the Master Agreement or some of the contracts in the bundle are governed by a foreign law¹⁸. This is due to the freedom for the parties to choose the law applicable to a netting agreement, which follows from Article 3 Rome-I¹⁹.

As the practice demonstrates, for most netting agreements under the ISDA Master Agreements either English or New York law is chosen. Other laws usually specified by parties as governing the netting agreement are the French, the German and the Spanish law²⁰. As a result, if a EU resolution regime is introduced, the law governing the netting agreement would be in most Member States often different than their law of the resolution regime.

Accordingly, resolution authorities would have no certainty as to whether the consequences of a temporary suspension of close out rights and of a transfer imposed by them would be recognised under the foreign law chosen. In other words, there would be no legal certainty whether these foreign contracts were (validly) transferred to a new party or whether they *de facto* remained in the estate of the failing credit institution.

The issue is even more apparent where the bundle of financial contracts contains property interests over book-entry securities, in particular under a pledge or other security interest.

According to Article 9(1) FCD²¹, the law governing a security interest derives from the place in which the relevant securities account is maintained. The same approach is followed by Article 24 of the Winding-up Directive²². Against this background, it is far from granted that this law would recognise a transfer of proprietary rights by a foreign resolution authority. As a consequence, property interests over securities might be regarded under that foreign law as being left behind in the failing credit institution, which entails the disassembling of the package of financial contracts covered by the original netting agreement.

¹⁸ See also on this in the previous section on partial transfers: *'The Services of DG Internal Market and Services consider that it would also be necessary to specify that where a resolution authority purports to transfer all of the property, rights and liabilities of a credit institution to another entity, but the transfer is or may not be effective in relation to certain property because it is outside the European Union, or to certain rights or liabilities because they are under the law of a territory outside the European Union, that transfer should not be treated as a partial transfer and should not be subject to the suggested safeguards.'* The focus in this section is mainly on agreements where the law of another Member State applies.

¹⁹ Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I Regulation).

²⁰ See the listing of commonly used Master Agreements in the report of the European Financial Markets Lawyers Group, reference in footnote 7, page 8.

²¹ Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

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. Article 24 of this Directive is entitled 'Lex rei sitae' and provides the following: *'The enforcement of proprietary rights in instruments or other rights in such instruments the existence or transfer of which presupposes their recording in a register, an account or a centralised deposit system held or located in a Member State shall be governed by the law of the Member State where the register, account, or centralised deposit system in which those rights are recorded is held or located.'*

Transfers of foreign property²³

The Services of DG Internal Market and Services believe that a provision is needed to ensure that, where a transfer of shares, other instruments of ownership, debt instruments, or assets, rights or liabilities includes:

- (a) assets that are located in a Member State other than the State of the resolution Authority ; or
- (b) rights or liabilities under the law of a Member State other than the State of the resolution authority ;

the transfer has effect in or under the law of that other Member State. In particular, Member States should provide the resolution authority that has made or intends to make the transfer with all reasonable assistance to ensure that the assets, rights or liabilities are transferred to the recipient in accordance with any applicable requirements of national law.

The Services of DG Internal Market and Services consider that creditors and third parties that are affected by the transfer of assets, rights or liabilities that are located in or subject to the law of a different Member State should not be entitled to prevent, challenge, or set aside the transfer under any provision of law of that other State. Such creditors and third parties should have the same rights and protections, including the right to compensation and the safeguards for partial transfers as creditors and third parties that are affected by the transfer of assets, rights or liabilities that are located in or under the law of the State of the resolution authority and, in particular, should receive compensation on the same terms, if applicable. This principle, if adopted, might require modifications to the Directive on the reorganisation and winding up of credit institutions (Directive 2001/24/EC) where the provisions of that Directive are inconsistent. Otherwise, the rights of creditors and third parties as against the recipient should not be affected, and the law governing those rights should be determined in accordance with the normal principles.

Finally, the Services of DG Internal Market and Service consider that where a transfer of shares, other instruments of ownership, debt instrument or assets, rights or liabilities includes assets that are located in a third country, or rights or liabilities under the law of a third country and the transfer is not immediately effective as a matter of the law of the relevant third country:

- (a) the transferor and the recipient must take all necessary steps to ensure that the transfer becomes effective ; and
- (b) the transferor must hold the assets or rights or discharge the liability on behalf of the recipient until the transfer becomes effective, and the recipient meets the expenses of the transferor in doing so.

The objective of the provisions suggested in this section is to ensure that where a transfer includes assets located in another EU Member State (e.g. in a branch) or rights and liabilities that are governed by the law of another Member State, the transfer cannot be challenged or prevented by virtue of provisions of the law of that other Member State. Are the suggested provisions sufficient to achieve this objective? Is any additional provision necessary?

²³ This section corresponds to Point G8 of the Crisis Management Consultation Paper; excerpt from pages 58-59.

One could argue that these substantive provisions on the treatment of foreign law assets caught by a transfer order should be supplemented by conflict-of-law rules.

Conflict-of-law rules in the Winding-up Directive

The conflict-of-law rules which would currently apply in such cases are mostly provided for in the Winding-up Directive. First of all, it is not clear whether the envisaged resolution measures would be regarded as "reorganisation measures" or/and as "winding-up proceedings" within the meaning of the Winding-up Directive. If they are regarded as being "reorganisation measures",²⁴ then Title II and Title IV of the Winding-up Directive would apply. If this is the case, apparent inconsistencies between Article 3, Article 23 and Article 25 of the Directive may cause problems in a resolution.

As a rule, Article 3 paragraph 2 of the Winding-up Directive provides that reorganisation measures are governed by the law of the home Member State, *"unless otherwise provided in this Directive. They shall be fully effective in accordance with the legislation of that Member State throughout the Community without any further formalities, including as against third parties in other Member States, even where the rules of the host Member State applicable to them do not provide for such measures or make their implementation subject to conditions which are not fulfilled"*.

At the same time, Article 25 of the Winding-up Directive stipulates that *"Netting agreements shall be governed solely by the law of the contract which governs such agreements"* which might be regarded as being a special conflict of laws rule in respect of Article 3²⁵.

Due to a lack of definitions there is uncertainty about the relationship between "netting agreements" provided for in Article 25 and "set-off" specified in Article 23 para 1 which provides that *"The adoption of reorganisation measures or the opening of winding-up proceedings shall not affect the right of creditors to demand the set-off of their claims against the claims of the credit institution, where such a set-off is permitted by the law applicable to the credit institution's claim"*. It has been argued on the basis of the identical Article 6 paragraph 1 of the Council Regulation (EC) No 1346/2000 on insolvency proceedings that the set-off protection is intended to include close-out netting²⁶.

However, if close-out netting is (also) covered by Article 23, then the additional question could arise whether its protection is then narrowed by Article 23 para 2, which states that the law of the home Member State decides on actions for voidness, voidability or unenforceability.

On the other hand, if transfer orders are regarded as forming part of "winding-up proceedings"²⁷, then Title III and Title IV of the Winding-up Directive apply. There appear to

²⁴ According to Article 2 intent 7 of the Winding-up Directive *"reorganisation measures" shall mean measures which are intended to preserve or restore the financial situation of a credit institution and which could affect third parties' pre-existing rights, including measures involving the possibility of a suspension of payments, suspension of enforcement measures or reduction of claims"*.

²⁵ This is the interpretation taken by the European Financial Markets Lawyers Group in a detailed analysis. See the paper referred to in footnote 7, page 33.

²⁶ The arguments in favour of this view are presented in the paper referred to in footnote above, p. 26.

²⁷ According to Article 2 intent 9 of the Winding-up Directive *"winding-up proceedings" shall mean collective proceedings opened and monitored by the administrative or judicial authorities of a Member State with the aim of realising assets under the supervision of those authorities, including where the proceedings are terminated by a composition or other, similar measure"*.

be corresponding inconsistencies between Article 10, which refers to the law of the home Member State, and the before mentioned Article 23 and Article 25.

Do Member States experts concur with the view that the current EU conflict-of-law rules on close-out netting are insufficient to deal with legal issues possibly arising from a special resolution regime on a cross-border basis?

Should the inconsistencies in current EU legislation be removed by clarifying the term "netting" and "set-off" and by applying the same terminology throughout the relevant EU aquis?

Possible solutions

The future EU legislation could provide that the EU resolution regime has overriding nature. According to Article 9 (1) Rome I Regulation *"Overriding mandatory provisions are provisions the respect for which is regarded as crucial by a country for safeguarding its public interests, such as its political, social or economic organisation, to such an extent that they are applicable to any situation falling within their scope, irrespective of the law otherwise applicable to the contract under this Regulation"*. However, even if future EU legislation stipulated that it was of overriding mandatory nature, this would not require courts of other Member States to apply the home Member State's implementation of the EU special resolution regime, unless the home Member State would be the place of performance of the netting agreement.²⁸

It seems that in order to achieve this goal future EU legislation would have to provide for a special rule on court jurisdiction, specifying that the courts of the Member State of the resolution authority have exclusive jurisdiction for all legal disputes relating to its activities taken on the basis of the special resolution regime. In such a case, the courts of that home Member State could apply the respective provisions of the special resolution regime as overriding mandatory provisions on the basis of Article 9 paragraph 2 Rome I Regulation²⁹.

However, the solution via "overriding mandatory provisions" does not provide for an overall remedy to possible legal problems because the requirements and legal steps necessary for a valid transfer of assets are also included in the general private law rules of the home Member State. Therefore, a more comprehensive option could be to introduce special conflict-of-law rules.

Do Member States experts believe that new conflict-of-law rules are needed to determine the law applicable to legal issues deriving from a temporary suspension of close-out rights and in result of a transfer of rights and liabilities covered by a netting agreement? Which law should be applicable? Should the relevant matters governed by such applicable law be explicitly named?

²⁸ According to Article 9 paragraph 3 of the Rome I Regulation *"Effect may be given to the overriding mandatory provisions of the law of the country where the obligations arising out of the contract have to be or have been performed, in so far as those overriding mandatory provisions render the performance of the contract unlawful. In considering whether to give effect to those provisions, regard shall be had to their nature and purpose and to the consequences of their application or non-application"*.

²⁹ According to Article 9 paragraph 2 of the Rome I Regulation *"Nothing in this Regulation shall restrict the application of the overriding mandatory provisions of the law of the forum"*.

IV. KEY DEFINITIONS

A number of definitions are set out in the above excerpts of the Crisis Management Consultation Paper including the following:

Pages 65-66

- (a) "close out right" refers to any right of a party to a netting arrangement to close out, terminate, accelerate or net contracts or liabilities ;
- (b) "netting arrangement" has the meaning given in Section H below (Partial transfers: safeguards for counterparties) ;
- (c) "failing credit institution" refers to a credit institution in relation to which the resolution authority of its home Member States has made a determination that the conditions for resolution are met ;
- (d) "business day" refers to any day other than Saturday, Sunday and any day which is a public holiday in the home Member State of the failing credit institution ;
- (e) references to time should be construed as the time in the home Member State of the failing credit institution.

Pages 69-70

- (b) Title transfer financial collateral arrangements under which collateral to secure or over the performance of specified obligations is provided by a transfer of full ownership of assets from the collateral provider to the collateral taker, on terms providing for the collateral taker to transfer assets if those specified obligations are performed ;
- (c) Set off arrangements under which two or more claims or obligations owed between the bank and a counterparty can be set off against each other ;
- (d) Netting arrangements under which a number of claims or obligations can be converted into a single net claim, including close-out netting arrangements under which, on the occurrence of an enforcement event (however or wherever defined) the obligations of the parties are accelerated so as to become immediately due or are terminated, and in either case are converted into or replaced by a single net claim.

Pages 71-72

- (c) "financial instruments" means transferable securities and money market instruments within the meaning of Article 4(18) and (19) of Directive 2004/39/EC and the following classes of instrument (irrespective of whether they are transferable securities):
 - loans or other instruments creating or acknowledging debt ;
 - units in collective investment undertakings ;
 - any option, future, swap, forward, contract for differences or other derivative contract (including all instruments listed in points (4) to (10) of Section C of Annex 1 to Directive 2004/39/EC) ;
 - any contract for the sale, purchase or delivery of transferable securities, currency, or commodities ; or
 - any combination of any such instruments.

Are these adequate, including in view of the definitions set out in existing EU legal instruments (for example those referred to in Footnote 7)? Should any of the latter be amended? Should additional terms be defined with a view to ensuring the effective resolution of a failing bank?

ANNEX: BIBLIOGRAPHY

The following papers were drawn on in preparing the discussion paper for the Working Group's 17 December meeting, including on the economic issues relating to close-out netting.

1. Allen & Overy LLP

Status of Close-Out Netting in the EU Member States

http://ec.europa.eu/internal_market/financial-markets/docs/cesame2/presentations/20100408-guest_status_report_en.pdf

2. Basle Committee on Banking Supervision

Report and recommendations of the cross-border bank resolution group

<http://www.bis.org/publ/bcbs169.pdf3>

3. Bergman, Bliss, Johnson and Kaufman

Netting, financial contracts, and banks: the economic implications,

<http://econpapers.repec.org/paper/fipfedhwp/wp-04-02.htm>

4. The European Financial Markets Law Group

- Protection for bilateral insolvency set-off and netting agreements under EC law
- The regulation of close-out netting in the New Member States of the European Union

<http://www.efmlg.org/Docs>

5. ISDA

The importance of close-out netting - ISDA Research Note

<http://www.isda.org/researchnotes/pdf/Netting-ISDAResearchNotes-1-2010.pdf>

6. Michael Krimminger (FDIC)

The evolution of US insolvency law for financial market contracts

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=916345

7. Philipp Paech (Institute for Law and Finance, University of Frankfurt)

Systemic risk, regulatory powers and insolvency law – The need for an international instrument on the private law framework for netting

http://www.ilf-frankfurt.de/uploads/media/ILF_WP_116.pdf

8. Enrico Perotti

Systemic liquidity risk and bankruptcy exceptions

<http://www.cepr.org/pubs/PolicyInsights/PolicyInsight52.pdf>

9. Mark Roe

Bankruptcy's financial crisis accelerator: the derivatives players' priorities in Chapter 11 –

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1567075##