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**LEGAL PROTECTION OF PAYMENT AND SECURITIES SETTLEMENT SYSTEMS AND
OF COLLATERAL TRANSACTIONS IN EUROPEAN UNION LEGISLATION**

by

Diego DEVOS

Deputy General Counsel

Legal Service

Bank for International Settlements

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Diego DEVOS
Deputy General Counsel
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I. Introduction

Over the past twenty years, and most notably since the start of the 1990s, the occurrence of credit institution insolvencies (Herstatt, BCCI², Banesto, Barings, Japanese banks, etc.), some of which have been sudden and completely unexpected, has led the authorities responsible for the supervision of payment and securities settlement systems, as well as operators of and participants in these systems, to be even more careful of the repercussions of insolvency on the satisfactory functioning of these systems, and in particular on the enforceability of collateral transactions carried out through such systems.

Control of the legal risks associated with the insolvency³ of a participant in a payment or securities settlement system is even more difficult when the insolvent participant is subject to a foreign legal system. This situation is very widespread, if one takes into account the participation of branch offices of foreign banks (whether or not incorporated under the law of a Member State of the European Union (the "EU")) in national systems. Furthermore, the "remote access" participation of foreign community banks⁴, an example of the free provision of services within the European Union area, increases the incidence of foreign participation in EU national systems.

¹ This paper is based on several studies published by the author in particular: « Collateral transactions in Payment and Securities Settlement Systems: the EU framework » in (Belgian) *Revue de Droit bancaire et financier*, 2002, pages 10-27; "The Directive 2002/47/EC on Financial Collateral Arrangements of 6 June 2002" published in September 2003 in "Mélanges offerts à Jean-Victor Louis" (Tribute to Professor Louis), Vol. II, with relevant updates where appropriate. The opinions expressed are strictly the author's own.

² See the special issue of the French Review "Banque & Droit" of April 1996 devoted to the insolvency of BCCI.

³ For convenience, the term "insolvency" will be used. However other proceedings based on a debtor's insolvency, or, more generally, on an agreement or moratorium between creditors, such as, in particular, judicial or amicable composition, voluntary winding-up, attachment proceedings, etc., must also be considered.

⁴ See Directive 93/22/EEC of 10 May 1993 on securities investment services (OJ L141 of 11 June 1993, p. 27).

In the past, it was sufficient for national payment and settlement systems to ensure that, in the event of the insolvency of a domestic participant, the local law applicable to the system would, for example:

- uphold the validity and enforceability against third parties of the netting of payments (in “net” settlement systems);
- uphold the contractual irrevocability of payment orders (in “gross” settlement systems);
- exclude any “zero hour” rules (backdating of the effects of insolvency decisions to the first hour of the day of the pronouncement of the insolvency decision); and
- uphold the enforceability of collateral arrangements that have been set up.

Today, it is also necessary, when a foreign participant enters insolvency, to make sure that the foreign law applicable to the insolvency will not invalidate the settlement of the cash or securities orders or the collateral arrangements put in place. Such issues fall within the area of cross-border insolvency⁵ which is currently one of the most complex legal issues facing market participants.

It is firstly the European Directive 98/26/EC of 19 May 1998 on Settlement Finality in Payment and Securities Settlement Systems⁶ (the “Settlement Finality Directive” or the “Directive”) which aims at addressing these issues and is devoted to the legal protection of payment and settlement systems as such, including the protection of collateral transactions processed in these systems. There is also a second important instrument at EU level which is the Collateral Directive of 6 June 2002 which is aiming at harmonising substantive rules on collateral arrangements irrespective of the systems or custodians through which the relevant collateral assets are held. For that purpose, we will consider below in Section II the main legal issues that may arise, before going on in Section III to describe two EU legal instruments likely to be of relevance. In Section IV, we will address the Settlement Finality Directive itself. In Section V, we will then review the provisions of the recent Collateral Directive. In Section VI finally, we will report on recent legal developments in the fields of clearing and settlement systems: The Hague Convention of 13 December 2002 on the law applicable to certain rights in respect of securities held with an intermediary, the Unidroit draft Convention on intermediated securities and the EU Legal Certainty Group.

⁵ Or, if one prefers, the private international law (conflict of laws) rules of each State; on cross-border insolvency, see in particular “International Bank Insolvencies, A Central Bank Perspective”, Editors Mario Giovanoli and Gregor Heinrich, Kluwer Law International, 1999.

⁶ JO L166 of 11 June 1998, p. 45 and following.

II. INSOLVENCY OF A FOREIGN PARTICIPANT IN A PAYMENT/SETTLEMENT SYSTEM

As we all know, there are two main approaches used by jurisdictions to address cross-border insolvency:⁷

- the principle of the unity of insolvency, by virtue of which there is only one competent court to declare a debtor's insolvency, that is, the court in the place where the insolvent company has its head office, registered office or statutory seat. This principle is generally linked to the principle of "universality" ("universal nature") of insolvency, allowing the insolvency decision to be enforceable and to produce legal effects in other States⁸ where branch offices or assets of the insolvent party are located (see, for example, the regimes in Belgium and Luxembourg);
- the principle of the "plurality" of insolvencies (or "territoriality"), which requires a declaration of insolvency in each country where the insolvent debtor has a centre of activities or even mere property. Under the territoriality approach, each insolvent branch is governed by its local insolvency law, is administered by its own receiver and such territorial insolvency only affects assets located in the territory in question (see, for example, the regimes in France and Denmark).

There are also systems which combine these two approaches in some way. An insolvency pronounced in the State of the insolvent party's domicile may indeed produce effects outside the territory of that State. On the one hand, the insolvency proceeding reaches other States where the insolvent party's property is located ("universality" of the insolvency), but, on the other hand, it is possible to institute a separate insolvency proceeding in the jurisdiction where local branch offices or even mere assets of the foreign debtor are located ("territorial insolvency"). This is the so-called "mitigated universality" principle in force, for example, in Germany, Austria and the United Kingdom.

In the case of insolvency of a foreign participant in a national payment and settlement system, the solution, as far as the jurisdiction of the system is concerned, will depend on the type of insolvency regime that is applied by a court in the jurisdiction of the payment and settlement system (the "Local Court"):

- In States that apply the "territoriality" principle of bankruptcy, the Local Court will simply refuse to recognise any insolvency decision handed down in the debtor's jurisdiction and will not apply the foreign insolvency law ("lex fori concursus"). In

⁷ Regarding these principles, see under Belgian law esp. Rigaux, *Droit international privé*, II, n° 1102 to 1104; N. Watté, "La faillite internationale...", note under Cass. 12 January 1990, RCJB 1993, p. 454 and following, particularly page 457 n° 8; M. Delierneux, "Les succursales face à la faillite", in "Les succursales bancaires" (Books AEDBF Belgium) 1996, p. 214 discussing the respective merits of the various existing solutions.

⁸ Subject, of course, to the recognition by these States of the insolvency decision and its effects on their territory, pursuant to the rules of private international law of the relevant court.

principle, a foreign insolvency should not have any impact on the payment and settlement system;

- In States that apply the “mitigated universality” principle, to the extent there is an establishment of the foreign debtor, or even mere assets, in the territory, there will generally (but not necessarily) be the opening of territorial insolvency proceedings in the Local Court limited to local assets. The national insolvency law of the place of the payment and settlement system will then prevail over the insolvency law of the foreign participant;
- In States applying the “unity and universality” principle of bankruptcy, the Local Court should, in principle, recognise the foreign insolvency order by right⁹ and also apply the foreign insolvency law.

The main qualifications to the automatic recognition of the foreign insolvency decision in such jurisdictions that apply the “unity and universality” principle will generally be as follows:

- there will be no judicial recognition if the foreign bankruptcy order is strictly limited by its terms or by nature to the territory of the foreign State;
- nor will there be any recognition if the application of the bankruptcy decision or foreign insolvency law is likely to be contrary to the international public policy¹⁰ of the State of the payment and settlement system¹¹. In this case, the local law will overrule the conflicting provisions of foreign law.

Here, the application of foreign insolvency law could be particularly detrimental to the proper functioning of national payment or settlement systems; it may then lead to the Local Court refusing to recognise the “lex fori concursus” because it would conflict with public policy¹².

Lastly, it is worth noting that certain courts may also refuse to recognise foreign insolvency decisions issued in countries that do not give reciprocal recognition to their own insolvency decisions¹³.

One good example of the practical application of the “unity and universality” approach, is the issue of the legal enforceability of collateral which secures the credit (intra-day or

⁹ Without, for example, formalities of “exaequatur”.

¹⁰ International public policy has a variable content, determined most often by jurisprudence, by reference to the ‘essential interests of the State or of the collectivity’ or to the ‘legal bases on which the economic or moral order of the State relies’, to take the Belgian example (Cass. 25 March 1968, Pas. I, 885).

¹¹ To the extent this recognition would likely affect the payment or settlement systems, with adverse consequences for other participants, so as to result in the possibility of systemic risk. The argument of international public policy, however, has never, to the best of the writer’s knowledge, been invoked or upheld in case law in such a context. This legal argument may be regarded as underpinning, in the writer’s opinion, Article 8 of the “Settlement Finality” Directive (see Section III below).

¹² One may also think about the non-enforceability of payment orders concerning the defaulting participant on the day of its insolvency, either for payments made before the insolvency (“zero hour”) or for those made between the time of the insolvency and the settlement of transactions of the insolvent participant.

¹³ In this sense in Belgium, see Comm. Brussels 20 June 1975, J.T. 1975, p. 641, which refers to the status of international public policy of the principles of unity and universality of insolvency; however this has been criticised by Rigaux, *Droit international privé*, II, n° 1103 end.

overnight) granted by a system operator or a central bank (the "Creditor") to a foreign participant (the "Foreign Debtor").

The enforceability of the collateral against third parties is governed by the law of the location of the collateral. This law, for example, may allow for the realisation of the collateral without any prior judicial authorisation.

However, in the case of insolvency or of any composition proceedings¹⁴ commenced against the Foreign Debtor in a court in the Foreign Debtor's jurisdiction, the foreign insolvency law might overrule the law applicable to the credit transaction and the related collateral because of the public policy nature of insolvency laws. This of course assumes that this foreign insolvency law would be recognised in the Local Court.

This does not mean that the validity of the main credit transaction or the collateral securing the transaction (a pledge, for example) would suddenly be governed entirely by a foreign law. One basic principle of the conflict of laws rules of most states is that a provision of collateral is governed, with regard to its proprietary aspects, in particular the enforceability against third parties and its realisation, by the law of the country where the assets are located ("lex rei sitae" rule). In this case, the local law of the Creditor is therefore still applicable to the assessment of the pledge's enforceability against third parties, with respect to the securities "located"¹⁵ in the Creditor's jurisdiction.

However, the Foreign Debtor's insolvency law – assuming it would be recognised by the Local Court – will have sole competence to govern two issues of crucial importance for the effectiveness (and not the validity) of the collateral in question:

- the determination of the ranking of the Creditor as collateral taker with respect to the collateral, that is, the order of preference on the proceeds of the assets encumbered by the pledge, vis-à-vis other preferential or ordinary creditors of the insolvent Foreign Debtor;
- the possibility of realisation of the relevant collateral, that is, whether it is necessary to obtain prior authorisation from the receiver or the competent courts before any realisation of the assets, as well whether or not there may be a stay on any action by secured creditors, in the interest of insolvency liquidation (the idea here is to leave a kind of 'inventory deadline' in order to freeze any legal action or forced sale by creditors before the receiver has been able to value the assets and liabilities of the insolvent Foreign Debtor and settle in court the disputable claims).

These matters are essential for the Creditor, because, in the case of the insolvency of a Foreign Debtor, it is important to ensure that the Foreign Debtor's insolvency law will

¹⁴ "Concordat", moratorium, "redressement judiciaire", receivership, suspension of payments, etc.

¹⁵ As there are more and more securities which are essentially dematerialised, that is represented exclusively from the outset by book-entries, one may consider (although hardly considered by legal doctrine so far) that the place of location of these securities is the place where the accounts, recording the relevant rights, in such securities, are held and operated; see in this sense Article 9.2. of the Settlement Finality Directive; see also the Convention of 5 July 2006 adopted by the Hague Conference on Private International Law on the law applicable to dispositions of securities held through an indirect holding system (see R.Potok, "The Hague Conference on Private International Law ...", *Journal of International Banking and Financial Law*, April 2001, p. 166; Potok and Bernasconi, "PRIMA Convention brings certainty to cross-border deals", *JILR* January 2003, 11)

give priority to the Creditor over the pledged assets, without preferring other creditors such as the tax authorities, social insurance bodies or employees. In addition, the Creditor must be able to immediately realise the securities in its possession, or at least as soon as possible, in order to avoid the risk ('market risk') that arises due to the possibility of a decline in the market value of the securities posted as collateral, independently of any margins which may have been constituted against such a risk. These issues are precisely addressed specifically in the Collateral Directive.

III. EUROPEAN LEGAL INSTRUMENTS RELATED TO THE SETTLEMENT FINALITY DIRECTIVE

In view of the diversity of the existing legal systems and the complexity resulting from the combination of several laws potentially applicable to an insolvent participant in a payment or settlement system, a harmonised solution at the European level was considered highly desirable. As we know, the Settlement Finality Directive is the binding EU legal instrument that aims at addressing the specific legal issues for payment and settlement systems, including collateral constituted in those systems.

However, there are two other EU instruments – recently adopted after the Settlement Finality Directive even though they were originally drafted before this Directive – which include provisions relevant for the protection of payment and settlement systems against the insolvency of participants.

It is appropriate to examine both instruments here as they have been a considerable source of inspiration for the Settlement Finality Directive, which will be analysed in Section III below.

1. *The European Regulation on Insolvency Proceedings dated 29 May 2000*

The work on a European Convention relating to E.C. insolvency proceedings, which began in 1959, ended on 23 November 1995, when a definitive text was signed (the "Insolvency Convention")¹⁶. It was the fruit of five years of intense efforts on the part of an ad hoc working group of national experts (chaired by the German BALZ). Because it required the signature of all Member States, the 1995 Insolvency Convention, following a joint initiative of Germany and Finland, was converted into an EU Council Regulation on insolvency proceedings (the "Insolvency Regulation") pursuant to Article 61 and 67 of the Rome Treaty. The Insolvency Regulation was finally adopted on 29 May 2000¹⁷ with the same provisions as those contained in the Insolvency Convention¹⁸. The Insolvency Regulation entered into force on 31 May 2002.

¹⁶ The Insolvency Convention was signed by all Member States other than the United Kingdom, Ireland and the Netherlands. Ireland and the Netherlands signed after the explanatory report of the Insolvency Convention was finalised. The United Kingdom, however, did not sign the Convention due to a conflict with other Member States over the so-called "mad cow" crisis. Under the Convention, the deadline for signature expired on 23 May 1996.

¹⁷ Official Journal n° L160 of 30.06.2000, p.1-13.

¹⁸ Recitals have been added in order to give some limited explanations, replacing, in a limited way, the draft explanatory report of the Insolvency Convention.

We do not intend to consider in detail this vast and complex instrument, which includes 47 Articles and three annexes, because the main focus of our study is not EU law on international insolvency in general.

We only mention in passing that the Insolvency Regulation establishes the principle of the “mitigated universality” of insolvency by means of a double set of rules, as follows:

- On the one hand, the first chapter of the Insolvency Regulation attributes principal competence to the jurisdiction of the Member State where the debtor’s domicile (or “centre of main interests”) is situated¹⁹ to commence insolvency proceedings (Article 3) – referred to as “main insolvency proceedings” – and provides that the insolvency law of this State will apply in the other States of the European Union (Article 4). Articles 5 to 15 of the Insolvency Regulation, however, set out exceptions to the basic competence of the law of the place of the main insolvency proceedings in favour of the laws of other Member States called upon to govern certain rights (real estate, employment contracts, rights in rem, etc.). It is within the latter framework that some protective provisions relevant for payment and settlement systems (and collateral) are laid down. Chapter II of the Insolvency Regulation provides for the automatic recognition of the main insolvency proceedings in the other States of the EU.
- On the other hand, Chapter III of the Insolvency Regulation authorises other Member States to open territorial proceedings – referred to as “secondary” insolvency proceedings – in their territory, if the debtor has an “establishment” there under the meaning of the Insolvency Regulation (see Articles 3.2 and 2(h)). The purpose of those proceedings is to “protect” such other States against the effects of the main proceedings (independently of the exceptions to the law governing the main proceedings, contained in Chapter I). In addition, Member States other than the State of the debtor’s head office are also authorised to open territorial insolvency proceedings independently of the opening of any main proceedings (subject to the fairly liberal conditions of Article 3.4). Chapter III organises relations between main and secondary proceedings (particularly, Articles 31 to 35).

It should again be noted - and this is important for our purposes - that the Insolvency Regulation, by harmonising the rules of conflict of laws and certain procedural rules in matters of international insolvency, is not applicable to the insolvency of credit institutions, insurance companies, investment firms and collective investment undertakings (Art. 1.2).

This exclusion is because of the existence of specific draft (at the time) EU instruments designed to cover the insolvency of these categories of financial institutions (particularly for banks and insurance companies) which takes into account the specific features of the financial sectors in which the categories of financial institutions operate and the principle of “home country control”, as key rule of supervisory control for activities in such sectors.

In view of this, it is obvious that the Insolvency Regulation has only a limited effect on payment and settlement systems because most of the participants in these systems are excluded from its scope of application. The fact remains that these provisions of the Insolvency Regulation may govern systems which may admit non-financial institutions, as well as to relations between a financial institution which participates in a system and

¹⁹ This is the application, first of all, of the principle of unity of insolvency.

its clients, which are ordinary commercial undertakings. The same debate about the scope of application has emerged during the Collateral Directive's discussions. Recital 27 of the Insolvency Regulation states explicitly that the Settlement Finality Directive must be considered as "lex specialis" and overrules the Insolvency Regulation as "lex generalis".

It is now time to examine the provisions of the Insolvency Regulation that are likely to concern payment and securities settlements systems or collateral, to the extent defined above. There are three relevant provisions, listed as follows:

- Article 5 relating to rights in rem;
- Article 6 relating to set-off;
- Article 9 relating to payment and settlement systems and financial markets.

As indicated above, these provisions act as a limitation of the exclusive application of the law of the main proceedings with certain rights governed by the law of another Member State.

a. Rights in rem

The first paragraph of Article 5 of the Insolvency Regulation states as follows:

"The opening of the insolvency proceedings shall not affect the right in rem of creditors or third parties in respect of tangible or intangible, movable or immovable assets - both specific assets and collections of indefinite assets as a whole which change from time to time - belonging to the debtor, which are situated within the territory of another Member State at the time of the opening of proceedings".²⁰

What is the scope of this provision?

The aim of Article 5.1 of the Insolvency Regulation is to ensure the maximum protection of the holders of rights in rem for assets located in other Member States, in view of the effects of the main insolvency proceedings opened in the country of the head office (or of the "centre of main interests") of the debtor.

The holder of the right in rem (including any pledgee creditor) may thus, first, realise the assets and claim a right of preference on the proceeds of this realisation without being hindered by any restrictive rules (or conferring on him a lower rank than that of other creditors) of *the law governing the main insolvency proceedings*.

So we can see the importance of this provision for situations where securities are provided as collateral (in relation or not to participation in a payment or settlement system) (compare, in this sense, Article 9.1 of the Settlement Finality Directive discussed below).

By doing this, the Insolvency Regulation also entitles the holder of the right in rem (or of the collateral) not to be hindered by any restrictive rules which apply in the case of insolvency *under the law which governs the (proprietary effects of the) right in rem itself*.

²⁰ The other paragraphs of Article 5 define "rights in rem" with reference to the attributes generally attached to these rights: right of realisation (pledge, mortgage), right to recover a claim assigned for security purposes, right of recovery, right to receive income ("fructus"), etc.

Applying the “lex rei sitae” rule, the law applicable to the right in rem normally corresponds to the law of the place of the assets subject to the right in rem.

In other words, the expression “does not affect” actually grants the holder of the right in rem the right to exercise its prerogatives (and particularly the right to realise the asset) in accordance with “ordinary” rules of the local law. The restrictive rules laid down in the local law (lex situs) for the insolvency of the debtor are thereby excluded.

So, in concrete terms, if (i) the debtor is domiciled in country A and is declared insolvent in country A and (ii) the creditor is domiciled in country B and is the recipient of a pledge of securities located in country B, the creditor may realise the collateral and be paid in accordance with the law of country B. The creditor in country B will however not be bound by the mandatory rules ordinarily applicable in the case of insolvency of any pledgor (debtor) under law B (such as, for example, the necessity to obtain a judicial authorisation prior to realisation).

By the “does not affect” formula, the Insolvency Regulation grants to the holder of the right in rem or of the security interest concerning an asset located in another country an even more favourable status than it would have under any relevant legislation in country A or country B applicable to its right in rem or its collateral since it “is not affected” at all by the opening of the insolvency proceedings.

We consider that this interpretation is confirmed in the draft explanatory report of the former Insolvency Convention²¹.

This draft report stated the following, under paragraph 98:

“The rule “does not immunise” rights in rem against the debtor’s insolvency. If the law of the State where the assets are located allows these rights in rem to be affected in some way, the liquidator (or any other person) empowered to do so may request secondary insolvency proceedings be opened in that State if the debtor has an establishment there. The secondary proceedings are conducted according to local law and allow the liquidator to affect these rights under the same conditions as in purely domestic proceedings”.

This passage thus clarifies the scope of the rule contained in Article 5 of the Insolvency Regulation:

- in the case of a main insolvency proceeding against the debtor, the creditor may exercise its rights in rem on local assets as if the insolvency proceedings did not exist;
- in order to apply any possibly restrictive provisions laid down in case of insolvency under the law of the State where the assets in question are located, a secondary insolvency proceedings must be opened. Failing this, these restrictive provisions are not applicable.

To sum up, Article 5 of the Insolvency Regulation enables the holder of collateral not only to be protected against an unfavourable “importation” of the insolvency law of the foreign debtor, but also of “not being affected” by this insolvency, so that the holder will

²¹ Version of 8 July 1996, doc 6500/1/96, commentary on Article 5 under paragraphs 94 and following, pages 70 and following.

be able to realise its collateral as if no insolvency had been opened (as long as no secondary proceedings are initiated in the country where the assets are located).

b. Set-off

Article 6.1 of the Insolvency Regulation states that

“The opening of (main) insolvency proceedings shall not affect the right of creditors to demand the set-off of their claims against the claims of the (insolvent) debtor, where such a set-off is permitted by the law applicable to the insolvent debtor’s claim”²².

This provision authorises set-off after the opening of the (main) insolvency of the debtor on the basis of claims arising previously²³, even if this “post-insolvency” set-off would be forbidden under the insolvency law of the jurisdiction in which the main insolvency proceedings have been commenced²⁴, provided that such a set-off is authorised by the law governing the insolvent debtor’s claim²⁵ (of course, this assumes that the applicable law is different to the law of the (main) insolvency proceedings).

This means, basically, in the financial area, that the contractual set-off governed by a law which authorises post-insolvency set-off, could be successfully claimed against the receiver of the (main) insolvency proceedings of a foreign debtor, despite the restrictions which might apply under the *lex fori concursus*²⁶ (compare Article 3 of the Settlement Finality Directive, commented on below under paragraph 24 or Article 8 of the Collateral Directive).

c. Payment systems and financial markets

Article 9 paragraph 1²⁷ of the Insolvency Regulations states as follows:

“Without prejudice to Article 5, the effects of insolvency proceedings on the rights and obligations of the parties to a payment or settlement system or to a financial market, shall be governed solely by the law of the Member State applicable to that system or market”.

This Article substantially ensures the protection of payment and securities settlement systems and the financial markets²⁸, because when a foreign participant is insolvent the effects of the insolvency proceedings on its rights and obligations in the system or

²² Article 6.2 preserves the right of the receiver or liquidator to commence actions for avoidance of transactions because of actual fraud to rights of the creditors or because of rules based on a “suspect period” (“preferences” or “fraudulent conveyances”).

²³ According to the explanatory report, n° 110 page 77.

²⁴ As is the case under the law of certain Member States (France, Belgium, Luxembourg, apart from notable exceptions (particularly concerning connected claims or for claims between financial institutions, for example).

²⁵ On the reasons of selection of the law applicable to the insolvent’s claim, see Report, n°108 p. 76.

²⁶ The report explicitly confirms this interpretation: n° 110, p. 76.

²⁷ As for the two other dispositions, paragraph 2 reserves the actions for fraudulent or prejudicial acts to the creditors but, contrary to Articles 5 and 6, Article 9.2 states that these actions will be governed, not by the law of the (main) insolvency proceedings, but by the law applicable to the system or market concerned.

²⁸ The notion of “financial market” is defined by the Report (p. 82, n° 120) and is similar to the one used in the Directive on Investment Services.

market in question will be governed exclusively by the law applicable to the system, to the exclusion of foreign insolvency law.

Consequently, the validity of “netting” in the case of insolvency or of gross payments settled in real time in an “RTGSS” [real time gross settlement systems], or again, the existence or not of a “zero hour” rule for transfers executed in the system, are to be assessed only according to the law of the system²⁹. The same applies, for example, to the validity of margin calls or transfer of positions (in favour of a non-bankrupt participant, as it is organised in certain options or futures markets).

This rule is also reflected in Article 8 of the Settlement Finality Directive (commented on hereafter (n° 36)).

The preservation of the effect of Article 5 of the Insolvency Regulation aims at avoiding the ‘blind’ application of Article 9, that is the exclusive application of the law of the payment system to collateral which constitute rights in rem (in particular, a pledge) on assets located in a Member State other than the one whose law governs the system³⁰. These collateral rights will still, in principle, be governed by the “lex rei sitae” and will “not be affected”, in the sense of Article 5 indicated above, by the opening of the insolvency proceedings.

2. EU Directive (2001/24/EC) on the reorganisation and winding-up of credit institutions of 4 April 2001³¹

Here again, we will not consider in detail this important directive. We simply note that in 1985, the Commission presented a draft directive, formally modified in 1988,³² with the aim of harmonising the reorganisation of credit institutions and their winding-up, according to the same principles of centralisation in the “home country”. Furthermore the directive will ensure mutual recognition of the measures taken by other Member States, along the lines of the basic regime that exists for the creation and exercise of banking activity within the EU, by virtue of the two so-called Banking Co-ordination Directives³³. The Directive relating to Deposits-Guarantee Schemes³⁴ had, moreover, completed the structure, by organising the mandatory affiliation of credit institutions to a deposit-guarantee scheme of the home Member State, also for its branch offices established in host Member States.

²⁹ In principle, this law will be the law of the Member State where the operator of the system is situated, which will, moreover, be generally stipulated contractually as “lex contractus”.

³⁰ See also the explanatory Report, p. 82 n° 124.

³¹ Official Journal n° L 125 of 5.5.2001, p. 15

³² Official Journal n° C 36 of 8.2.1988, p. 1.

³³ Directive 77/780/EEC of 12 December 1977 (Official Journal n° L 322 of 17.12.1977, p. 30) as modified by the Second Directive 89/646/EEC of 15 December 1989 (Official Journal n° L 386 of 30.12.1989, p. 1).

³⁴ Directive 94/19/EC of 30 May 1994, Official Journal n° L 135 of 31.5.1994, p. 5.

The work on the “reorganisation/winding-up” Directive began again in 1993, after a hiatus of several years, and ended³⁵ with a Common Position at the E.U. Council level in May 2000. After last amendments of the European Parliament, the Directive (“the Directive” or the “WUD”) was finally adopted on 4 April 2001 which should have now been implemented by Member States since 5 May 2004 (Article 34.1).

The Directive is still fundamentally based on the principle of the exclusive competence of the administrative or judicial authorities of the home country of the bank in difficulty. These authorities are solely entitled to decide on the adoption of reorganisation measures or the opening of a winding-up proceedings (in the broad sense), with application of the home country’s law.

The authorities in the host Member State must recognise the effects of these measures, without being able, on their part, to take reorganisation measures locally, or to open territorial insolvency proceedings against the branch offices set up in their territory.

Therefore, for the European banking sector (as well as for the insurance sector), this Winding-up Directive applies the principles of unity and universality of bankruptcy, and thus differs quite substantially from the approach adopted by the Insolvency Regulation, which is based on “mitigated universality” (that is, a main insolvency proceedings accompanied by secondary insolvency proceedings in each State where an establishment of the debtor is located).

However, the European Council felt it necessary to depart, to some extent, from the application of the home country’s law in favour of the law of other Member States, in order to govern certain rights. This means not only providing a compromise to ‘territorial’ States, but above all, avoiding a situation in which the generalised application of the home country’s law might prove to be seriously detrimental to legal certainty, particularly for financial transactions and the participation of the credit institutions in question in payment or settlement systems (or financial markets).

The Winding-up Directive thus sets out a series of exceptions to the law of the home country, including those which deal specifically with the protection of financial transactions and payment or settlement systems.

The most important provisions for our purposes are Articles 20 to 33 of the Winding-up Directive, which adopts a similar approach to that of the Insolvency Regulation³⁶, in the sense that, as waiver of the home country law, the effects of the reorganisation measures or winding-up proceedings on certain rights, contracts or systems concerning the insolvent bank will be exclusively governed by another law, that is, the one applicable to these rights, contracts or systems.

³⁵ It was rumoured that the work on this draft Directive had then been placed on hold due to a dispute between the United Kingdom and Spain concerning the application of this Directive to Gibraltar.

³⁶ See Articles 5 to 15 of the Insolvency Regulation concerning exceptions to the application of the law of the main insolvency proceedings.

The validity of **contractual netting**,³⁷ and “**repurchase**” **agreements** or “**repos**”³⁸ will be indeed governed exclusively by the *lex contractus*³⁹. The enforcement of **proprietary rights in book-entry securities**, recorded on a register, an account or in a centralised deposit system held or located in a Member State, will be exclusively governed by the law of the Member State where the account, the register or centralised deposit system *in which those rights are recorded*, is held or located.⁴⁰ **Transactions carried out in the context of a regulated market** shall be governed solely by the law of the contract governing such transactions.⁴¹

The Winding-up Directive applies also the same regime than the Insolvency Regulation in the treatment of rights in rem, which “shall not (be) affect(ed) by the adoption of reorganisation measures or the opening of winding-up proceedings” when the relevant assets are “...situated within the territory of another Member State at the time of the adoption of such measures...” (Article 21).

Since the opening of insolvency proceedings in the home Member State “does not affect” the holder of the right in rem, there will be an “immunisation” of the holder of such a right in rem, taking into account the absence of any possibility to open a secondary insolvency proceedings in other Member States. In such a regime, the holder of the right in rem should thus be exempted from any restrictive rules intending to avoid abuses to the detriment of other creditors – whether under the insolvency law of the home Member State or under the law of other Member States applicable to the holder’s right in rem or security interest.⁴² This is also what the Collateral Directive is aiming to achieve (see in particular Articles 4, 8 and 9 of the Collateral Directive).

One will also note that the same principles (and exceptions with respect to certain categories of contracts and rights) are laid down in the EU Directive 2001/17/EC on the reorganisation and winding-up of **insurance undertakings**⁴³ (see in particular Articles 19 to 28⁴⁴) which should have been implemented at national level since 20 April 2003.

³⁷ Article 25.

³⁸ Article 26.

³⁹ Subject, for repurchase transactions, to the enforceability against third parties of the transfer of ownership as determined by the law of the country where the relevant securities are transferred (this is the meaning of the ‘without prejudice to Article 24’ – referring to *lex rei sitae* rule with respect to book-entry securities – introduced in Article 26).

⁴⁰ Art 24 (‘*Lex rei sitae*’). Compare paragraph 38 below on Article 9.2 of the Settlement Finality Directive or the rule proposed in the Hague Convention (see hereafter)

⁴¹ Art 27, again subject to *lex rei sitae* as laid down in Article 24.

⁴² Compare with Article 9.1 of the “Finality” Directive, which has also adopted such a rule of exoneration; see paragraph 37 below.

⁴³ Official Journal n° L 110 of 20.04.2001, p. 28

⁴⁴ See however some differences of substance, in particular in Article 23 (reference to the “law applicable to (the regulated) market” instead of the “*lex contractus*”, as in the WUD). There are no reference neither to netting or repo, nor to book-entry securities, except in Article 25.

IV. THE SETTLEMENT FINALITY DIRECTIVE⁴⁵.

The Settlement Finality Directive is the product of a group of Member States experts under the aegis of the European Commission, set up in 1993 in order to study the legal aspects of cross-border payments⁴⁶.

The Directive proposes legislation at the EU level that eliminates as far as possible the main legal risks to which payment systems and securities settlement systems are exposed at present, and to which we already referred previously,⁴⁷ taking into account the systemic risk⁴⁸ inherent in such systems.

The idea here is, first of all, to require Member States – if they have not already done so – to ensure that their domestic law ensures the satisfactory functioning of payment and settlement systems, whether operated on a net basis, in which case the validity of netting must be ensured, or on a gross basis, where the contractual irrevocability of orders needs to be guaranteed. There is also the need for the removal of any “zero hour” rule in the case of the insolvency of a participant.

A second objective, which is of no less importance, is to ensure that the functioning of the relevant system, once its domestic law has been strengthened, cannot be threatened by the application of foreign insolvency legislation, in the case of the participation of an institution from another Member State or even from a non-EU country.

Once these protections are in place, financial institutions (mainly credit institutions and investment firms) should be able to settle their transactions in Euro or other currencies without major legal risks, not only by means of national systems for “domestic” transactions, but also by means of cross-border payment systems such as the TARGET

⁴⁵ Official Journal n° L166 of 11 June 1998, p. 145; the initial proposition concerning “the finality of settlement and guarantees” was presented by the European Commission on 30 May 1996 (Official Journal C 259 of 18 July 1996, p. 13) and later amended, following the first opinion of the European Parliament (JO C 259 of 26 August 1997, p. 6); on the Directive, see our study in *Euredia* (European Banking & Financial Law Journal), 1999, 2, pp. 149-85; J. Richards and M. Evans “The Settlement Finality Directive - The End or the Beginning of the Story”, *Travers Smith Braitwaite* (16th Annual Seminar on International Financial Law organised by International Bar Association on 21 May 1999); M. Vereecken, “Reducing systemic risk in payment and securities settlement systems”, *Journal of Financial Regulation and Compliance*, vol. 6, n° 2 (May 1998), p. 107 and following; P. Bloch, “The Directive 98/26/CEE concerning the finality of settlement in the payment and securities settlement systems”, in *Banking and Financial Law (Mélanges AEDBF-France)*, II (1999) which undertakes a comparative analysis of the Settlement Finality Directive and French law on the subject.

⁴⁶ For background on the work of this group of experts, see our study on The European Directive 97/5 of 27 January 1997 concerning cross-border credit transfers, *Rev. Banque* 1998, p. 43 and following, particularly p. 47 n° 7.

⁴⁷ See Recitals 1, 2 and 4 of the Settlement Finality Directive

⁴⁸ That is, the risk that the insolvency of a participant in a payment or settlement system, or a financial market, might cause in turn the insolvency of other participants.

system⁴⁹ managed by the national central banks of the Euro system and the European Central Bank, or the EURO 1 system⁵⁰ for cross-border transactions in the Euro area.

The same applies to securities transactions which can be settled on a cross-border basis, either in international central securities depositaries (such as Euroclear or Clearstream) or by means of connections ("links") between national central securities depositaries, in order to allow securities, held in a country Y, to be transferred from party A to party B, both located in a country X, to take a simple example.

Finally, monetary policy or exchange transactions of central banks – and particularly those which are members of the European System of Central Banks within the Euro area – should also benefit from the legal protection brought by the Directive. The collateral provided to these central banks (as well as the collateral provided by or to other participants in EU systems) to guarantee e.g. extensions of credit should no longer run the risk of being rendered ineffective or unenforceable in the case of the counterparty's insolvency. This also includes intra-day credit, which is important for the satisfactory functioning of payment systems.

⁴⁹ Target is a connection of national payment systems operating a real-time settlement of "gross" amounts, without netting. On the Target system, see J. Lachand, "The Target System", Bull. Banque de France, June 1995, p. 97 and following.

⁵⁰ A net payment system in Euro managed by an inter-banking association named "Eurobanking".

1. **Scope of application of the Settlement Finality Directive**

a. Scope “Ratione Materiae”

The provisions of the Directive apply to any payment or securities settlement system within the meaning of Article 2(a) of the Directive, that is:

- a formal arrangement (comprising common rules and standardised arrangements) between 3 or more participants⁵¹, for the execution of transfer orders (on cash or securities) between the participants;
- designated as a “system”⁵² by each Member State, which must notify it to the Commission “after that Member State is satisfied as to the adequacy of the rules of the system”. Each national system must be assessed on the basis of an “accurateness” criterion, which is subject to the satisfaction of each Member State. In reality, this provision is a compromise between those that favoured harmonised supervision of payment and settlement systems⁵³ and those opposed to any harmonisation on this point, who consider that the Directive should just focus on reducing the legal risks associated with these systems.

Each Member State is also free to designate as a system, on a case-by-case basis, a formal arrangement (as defined above) which only includes two participants – which can cover correspondent banking relationships – provided that this designation, in the opinion of the Member State concerned, is warranted on grounds of systemic risk.⁵⁴

In the same vein, each Member State may also treat an indirect participant (or sub-participant)⁵⁵ as if it were a direct participant in a system as defined above, in order to apply the protective provisions of the Directive to bilateral relations between the direct participant and the indirect participant, provided the following conditions are fulfilled:

- the “indirect participant” must be a credit institution;
- the direct participant must be an institution which participates in a payment system (securities settlement systems have been excluded; one may wonder why such a differentiation has been made);
- there must be a contractual relationship between the direct participant and the indirect participant (on these three first conditions, see Article 2(g));

⁵¹ Not including a settlement agent, clearing house or any other intermediary party of this type.

⁵² The Settlement Finality Directive adds: “without prejudice to other more stringent conditions of general application laid down by national law”; on the meaning of these terms, see below.

⁵³ See also Article 10.3 indicating that Member States may impose supervision or authorisation requirements on systems. See in this respect the regulatory standards applicable to securities settlement systems laid down in the “Recommendations for securities settlement systems” of November 2001 adopted by the Committee on Payment and Settlement Systems (“CPSS”) together with the Technical Committee of the International Organisation of Securities Commissions (IOSCO).

⁵⁴ Art 2(a), final paragraph.

⁵⁵ That is, a credit institution or another financial institution which processes its cash or securities orders by the intermediary of a direct participant, being the member of the system in which these orders are settled.

- the inclusion of indirect participants in the category of “participants” in the sense of the Directive must be warranted on the grounds of systemic risk, in the opinion of the Member State concerned (Article 2(f));
 - the indirect participant must be “known” to the system in which it participates via its direct participant (Article 2(f)). The system must also disclose to the Member State in question (the one whose law is applicable) the participants in the said system, including any possible indirect participants, as well as any change in them (Article 10).
- b. Scope “Ratione Personae”

According to Article 2(b), direct participants in a system may be (i) credit institutions as defined in the First Banking Co-ordination Directive⁵⁶, (ii) investment firms as defined in the Directive on Investment Services⁵⁷, (iii) public authorities and publicly guaranteed undertakings or (iv) any undertaking whose head office is outside the EU and whose functions correspond to those of the EU credit institutions or the aforesaid investment firms.

Central counterparties, settlement agents and clearing houses are also included in the scope of application of the Directive (see Article 2(c), (d), and (e)).

All these categories of institutions are included in the general concept of “participant” in the sense of Article 2(f).

c. Scope “Ratione Territoriae”

Contrary to the initial proposal of the Commission, the Directive is limited to EU systems only, that is, those governed by the law of a Member State chosen by the participants (Articles 1(a) and 2(a), second indent)⁵⁸, even though, of course, these systems may include participants with a registered office established in a non-EU country, acting through a branch office located in the EU.

Recital no. 7 states, however, that Member States may apply the provisions of the Directive to their domestic institutions which participate directly in non-EU (payment and securities settlement) systems.

At this stage, it might be helpful to explain the effects the Directive might have on relations between **EU** institutions and systems and institutions or systems of **non-EU countries**.

First of all, it goes without saying that the power left to Member States to apply the Directive to their institutions which participate in non-EU systems does not mean that such non-EU countries would be bound by the Directive. The Directive is only binding on Member States of the EU in order to ensure that their domestic law satisfies the objectives of legal soundness and certainty. What is true, however, is that in the case of

⁵⁶ Directive 77/780/EEC of 12 December 1977 (Official Journal n° L 322 of 17 December 1977, p. 30), Article 1.1.

⁵⁷ Directive 93/22/EEC of 10 May 1993 (OJ L141 of 11 June 1993, p. 27), point 2 of Article 1.

⁵⁸ It is fairly bizarrely stated, in the second indent under Article 2(a), that “participants may only choose the law of a Member State in which at least one of them has its head office”.

“insolvency” of EU institutions participating in a system operating in a non-EU country, the non-EU system will be entitled to rely on the “protective” effects of the Directive. In this case, the Directive extends its effects to the domestic law of a Member State, in so far as its provisions (concerning netting, irrevocability of transactions, zero hour rules, and collateral) will also be binding on the (domestic) receiver of the insolvent institution in order to prevent the invalidation of the operations of the non-EU system. Such a regime should favour the participation of EU institutions in American, Japanese or Swiss systems, for example.

On the other hand, in the case of insolvency of non-EU institutions participating in an EU system, the “protective” provisions of the Directive should prevent the receiver of the non-EU country from challenging the operating rules of the EU system or any collateral arrangements, on the grounds, for example, of their incompatibility with the mandatory rules of the insolvency law of the non-EU jurisdiction (assuming of course, that the insolvency proceedings of the non-EU country would be, as a starting point, recognised in the Member State where the system is located).

One should consider, in such a case, the protective provisions in question (introduced into domestic law of each Member State when implementing the Directive) as part of the international public policy of the Member State where the system in question is operated, preventing the application of conflicting rules of the non-EU country’s law.

The Directive also authorises Member States to designate as “systems” securities settlement systems which allows “to a limited extent” the execution of orders concerning financial instruments other than “securities” as defined in Article 2(h) (see Article 2(a)); what is intended here are, for example, transfer orders on gold or other commodities, which are covered under the concept of “commodity derivatives”). A system which grants access to non-financial institutions can also be designated as a “system” (for example, large companies (“corporates”) carrying out financial transactions), provided that, for such cases, the system in question is a securities settlement system supervised in accordance with national legislation (see Article 2(b), final paragraph). In both cases, designation as a “system” must again be warranted on the grounds of protection against systemic risk.

As one can see, Article 2 of the Directive refers to systems’ criteria (“formal arrangement”, justification of “systemic risk”, verification “of the adequacy of the rules of the system”, etc.) which appear to be fairly vague and general, and therefore require a formal designation by each Member State, in its implementing legislation or by means of subsequent enforcement regulations, independently of the notification of the national systems to the European Commission, required by Article 10, paragraph 1 of the Directive.

2. Provisions of material law aimed at the legal protection of payment and settlement systems.

Article 3 of the Directive is probably one of the most ambiguous provisions (with Recital 13; see below) and one of the least well drafted, from a strictly legal point of view, of the whole text of a directive which is not known for its clarity.

It is the outcome of a political compromise, aimed at merging two initially separate texts, one devoted to the validity of netting, the other to the validity of transfer orders in

general. The result, alas, is an ambiguous text which may undermine the legal certainty which it was meant to provide.

The first objective of Article 3.1 is to ensure the validity and, particularly, the enforceability against third parties of the “netting of payments”, in the event of the insolvency of a participant in a payment or settlement system operating on a net basis.

Both bilateral netting and multilateral netting, by set-off, novation or any other technique (the German “Skontration”, for example), are included in this provision (see the rather economic definition of “netting”⁵⁹ in Article 2(k), referring to the conversion of reciprocal claims into a “single net” claim⁶⁰).

Netting of forward contracts (swaps, repurchase transactions, etc.) (known as “Obligation Netting”) could also be caught, at least indirectly, if operated within the framework of a system in the sense of the Directive. One good example was the ECHO system managed in London by the ECHO Clearing House which has now been replaced by the CLS system. The Collateral Directive is now aiming at expressly validating close-out netting provisions (as stipulated in various market agreements: ISDA swap master agreement, ISMA Global Master Repurchase Agreement, European Master Agreement, etc...) notwithstanding insolvency proceedings against a counterpart (Article 7).

The way in which Article 3.1 is drafted (“Transfer orders and netting shall be legally enforceable and ... shall be binding on third parties provided that transfer orders...”) could be interpreted, first of all, as limiting the scope of this paragraph only to the netting of transfer orders, in other words, as applying only to payment or settlement systems which operate a liquidation on a net basis, to the exclusion of transfer orders executed in gross settlement systems (“RTGS systems” for short, which operate an individual settlement of each order for its initial gross amounts, without netting).

Article 3.2, which only protects netting (without reference to transfer orders) against preferences rules (transactions during the “suspect period”) would appear, at first sight, to confirm this narrow interpretation. This is corroborated by Recital 11, which stipulates that “transfer orders and their netting should be legally enforceable...”.

Although this concept may have been in line with the Commission’s initial proposal for a directive, this was definitely not the objective sought by most, if not all, Member States, who wanted to protect transfer orders generally against the effects of insolvency whether these orders would be settled on a “net” (which is becoming less frequent) or on a “gross” basis.

It is therefore appropriate to adopt a broad and reasonable interpretation of Article 3.1, so that it applies not only to the netting of transfer orders, but even to **transfer orders, independently of any subsequent netting**. But the scope of this provision is still unclear:

⁵⁹ Translated as “compensation” in the French version of the Directive.

⁶⁰ On the legal aspects of “netting”, see P. R. Wood, “Principles of Netting : A Comparative Law Study”, NIBE – Bank Juridische Reeks (20), Nederlands Instituut voor het Bank – en Effectenbedrijf (1994); see also our study on the matter with regard to Belgian law in “Revue de la Banque” 1994, p. 162 and following.

- If the first paragraph of Article 3.1, aims at ensuring the validity and enforceability against third parties of transfer orders entered into a system before the opening of insolvency proceedings (which is the basic hypothesis), what does this mean? Is it a protection against a revocation or against a “zero hour” rule in the case of insolvency, in which case, of what use would then be Articles 5 and 7, which deal specifically with these cases?
- Is it, on the other hand, a matter of ensuring that a payment order entered into a system before insolvency can always be settled validly after this time? Can one, in particular, infer from the text of the first paragraph of Article 3.1 that a payment order entered into a “RTGS system” before the insolvency but which is not settled immediately (after being placed in a “waiting queue” for example) can, however, be processed and settled without any hindrance after the insolvency? In our opinion, one should answer this question in the affirmative to the extent that the text of the first paragraph of Article 3.1 renders the validity and enforceability against third parties of transfer orders solely contingent on their prior entry into the system, which must take place before the opening of the insolvency proceedings against the participant concerned. To make any sense, this should imply the admissibility of the subsequent settlement of such previous orders.

The second paragraph of Article 3.1 deals with the case of transfer orders carried out on the day of opening of such proceedings, but entered after the opening of insolvency proceedings⁶¹. This second paragraph was introduced in the Directive in order to remedy the legal uncertainty affecting the fate of payments orders made between the time of insolvency and the moment of its knowledge by the participants and operators of the systems concerned. It goes without saying that participants who are debtors of the insolvent participant following a bankruptcy order that was issued, for example at 11 o'clock on any one working day, may be led to make further orders after this moment, being unaware of the occurrence of this insolvency. Also, it is possible to imagine that the insolvent participant orders payments after its insolvency. For example, the payments could have been entered with an order of delayed execution or the orders could have been passed by another (direct) participant in the system representing the defaulting institution, at the time when this direct participant does not yet know about the insolvency of the defaulting institution.

These orders subsequent to the declaration of insolvency are declared legally enforceable and binding on third parties “only if, after the time of settlement, the settlement agent, the central counterparty or the clearing house can prove that they were not aware, nor should have been aware, of the opening of such proceedings” (paragraph 2 of Article 3.1).

In case of dispute about transfer orders entered after the opening of insolvency proceedings against the participant, it is up to the settlement agent or the operator of the system to prove its legitimate ignorance of the insolvency at the time of settlement. The settlement agent or operator must be able to justify its legitimate ignorance by demonstrating that at the time of the orders and their execution, the competent authority

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On this point, see below our comment on Article 6 of the Directive.

in accordance with the rules stated in Article 6 of the Directive (see below) did not provide the settlement agent or operator with the news of the insolvency of the relevant participant, nor was the insolvency known to the markets (through, for example, reference to announcements in the press or on Reuters, Telerate or Bloomberg screens).

In the same way and under the same conditions as for the transfer orders themselves, Article 3.1 allows for the protection of netting (see paragraph 25 above) of transfer orders provided that:

- either the transfer order to be netted is entered into the system before the moment of opening of the insolvency proceedings;
- or the transfer order was introduced and settled on a net basis after the moment of opening of insolvency proceedings, to the extent that the operator of the system can prove its legitimate ignorance of the opening of such insolvency proceedings.

Article 3.2 deals with the protection of the effects of netting⁶² against the possible damaging impact of rules on fraudulent transactions carried out during a certain period (six months, two years, etc.) before the opening of the insolvency proceedings (referred to variously as the “suspect period”, *fraus pauliana*, regime of “preferences”, “fraudulent conveyance”, etc.). It is stipulated that netting may not be unwound as a result of these rules.

Article 3.3 states that, for the purposes of application of Article 3.1, the moment of entry of a transfer order into a system is defined by the (operating) rules of the system. This appears to be rather obvious. Unfortunately, the text adds that if the national law itself defines this moment, the rules of that system must be in accordance with such conditions. At this point, one may question the usefulness of the first sentence of Article 3.3.

Article 4 of the Directive allows Member States, despite the insolvency of a participant, to authorise the debit (in cash or securities) of a settlement account of this participant⁶³ in order to allow for the settlement of its final position or of its transfer orders. This could be carried out either by the debit of cash amounts or securities already credited on such an account or even by means of a withdrawal on a credit line extended to the defaulting participant by the central bank or the operator of the system. In this latter case, the central bank or the operator of the system is not required anymore to obtain the prior authorisation of the receiver as regards this use of credit facilities. However, the relevant credit facility so used has to be already secured by means of “available existing” collateral, taking the form of collateral security as defined under Article 2(m).

Article 5 aims at ensuring the irrevocability of transfer orders. In most cases, this will be provided for in the rules of the system, which should then be protected against any rules

⁶² To the exclusion of the transfer orders, not covered under the terms of this paragraph.

⁶³ For example, a current account opened at the central bank or with the system’s operator.

of internal law⁶⁴ which may invalidate this irrevocability, including in the case of the insolvency of a participant.

Pursuant to Article 5, from the moment of irrevocability defined in the rules of the system, a transfer order can no longer be revoked by a participant or by a third party (receiver's participant, customer, etc.).

Section III of the Directive contains three provisions (Articles 6 to 8) which deal with the opening of insolvency proceedings against a participant of a system⁶⁵.

Article 6.1 defines the moment of opening of insolvency proceedings as the moment when the relevant judicial or administrative authority "handed down its decision".

This definition is useful for the interpretation of Article 3 (protection of netting and transfer orders entered into the system) and Article 7 (protection against any "zero hour" rule).

When a decision opening insolvency proceedings is handed down by the relevant authority (for example, by a commercial court), the relevant authority must immediately notify that decision to the appropriate authority designated by its Member State to receive such notification (Article 6.2). This national authority (which may be the central bank), must in turn immediately pass on this news to other Member States (the authority in question must in practice notify the decision taken in its country to its foreign counterparts).⁶⁶ Member States are also obliged to inform the Commission of the authorities which they have appointed for this purpose (Article 10, paragraph 1).

One must not lose sight of the fact that, however useful this notification system may be, the moment of opening of insolvency proceedings remains, in principle, when the relevant authority of a country A hands down its decision, and not the moment when this decision is notified to the appropriate authority of country A, nor, the moment when the decision is passed on to the other Member States, subject, of course, to the rules of national law applicable in each Member State concerned.

However, a degree of protection is conferred by the rules that protect transfer orders executed (without knowledge of the insolvency) between the time of insolvency and the moment when this news is widespread on the markets (see paragraph 2 of Article 3.1, described above).

Article 7 aims at neutralising the rules under some insolvency regimes under which an insolvency decision is deemed to have retroactive legal effects from the first hour of the day of its pronouncement (the so-called "zero hour" rule).

⁶⁴ For example, based on the revocability of the agency /mandate.

⁶⁵ In reality, all the provisions of the Directive particularly deal with the incidence of insolvency proceedings opened against a participant, as shown also by Articles 3, 4 and 9 even if the bankruptcy or insolvency in general is not the only relevant possibility.

⁶⁶ There is a discrepancy here between the English text of the Directive (the original text) simply referring to "other Member States" and the French text pointing more specifically to the "other Member States concerned". The idea here was in fact to require the national authority of countries where the insolvency is opened to notify this news to all the other Member States, without the national authority being required to assess which Member States are "concerned" and therefore should receive notification.

“Zero hour” rules result in the insolvent party being deemed to have lost its legal capacity from the first moment of the day on which the insolvency decision was handed down. Therefore, the transactions and payments that it carried out between the first hour of the day of insolvency and the moment when the decision declaring its insolvency was handed down, are void or voidable, and at least not enforceable against the receiver.

Zero hour rules are of course totally inappropriate for inter-bank transactions at the beginning of the 21st century. It is imperative, especially in a gross settlement system, that a recipient can consider a payment received as “final” and be able then to freely dispose of or transfer it in favour of third parties. Article 7 states therefore that an insolvency proceeding cannot have retroactive effects on “the rights and obligations of a participant arising from, or in connection with, its participation in a system”. This provision mainly concerns the validity of the transfer orders executed and of collateral provided before the opening of the insolvency proceedings. The same type of rule is also proposed in the Collateral Directive (Article 8.1.).

This rule is of general application, whatever the type of system (“net” or “gross”)⁶⁷.

This neutralisation of the “zero hour” rule in the case of insolvency of a participant in a system, could, however, be subject to qualification arising from Recital 13, which it is appropriate now to discuss further.

Recital 13 of the Directive states that “nothing in this Directive should prevent a participant or a third party [for example a receiver] from exercising any right or resulting from the underlying transaction which they may have in law to recovery or restitution in respect of a transfer order which has entered a system, e.g. in case of fraud or technical error, as long as this leads neither to the unwinding of netting nor to the revocation of the transfer order in the system”

As the title of the Settlement Finality Directive indicates, the idea of some Member States was to ensure the “finality”, or rather the definitive character of the settlement (“settlement finality”) of transfer orders processed in payment or settlement systems, and not the “finality” or definitive status of the payments themselves (“payment finality” or “receiver/beneficiary finality”).

Under this view, reflected in Recital 13, the netting of transfer orders and the orders themselves can no longer be invalidated or unwound (paragraphs 1 and 2 of Article 3.1), a transfer order can no longer be revoked after the time authorised by the system (Article 5), insolvency proceedings against a participant can no longer retroactively affect its rights and obligations linked to its participation in a system (Article 7), as far as “the system” is concerned.

But, still in this narrow interpretation, the participant who gives the order, or its receiver, might always act directly against the beneficiary participant (or a subsequent beneficiary) “outside the system” in order to claim back or to recover the amount transferred (cash or securities) “in the system”. This would not only be possible in case

⁶⁷ One points out however that it does not cover the fate of payments made after the moment of opening of insolvency proceedings, but in the ignorance of the latter, except to apply Article 3.1, paragraph two, to them (see above).

of mistake⁶⁸ or fraud⁶⁹ – which goes without saying – but also, in all other circumstances⁷⁰ in which such a recovery claim could be available pursuant to national law.

In other words, Recital 13, together with the wording of some provisions of the Directive (Articles 3, 5, 7, 9), could be interpreted, taking a particularly narrow view, as meaning that a receiver would be authorised to act “outside the system” – for example by claiming back the sums paid as a consequence of a netting carried out on the day of insolvency – as long as the netting itself is not called into question “in the system”.

Yet again, the payments made by the insolvent participant on the day of its insolvency but prior to the declaration of the insolvency order, could be subject to recovery actions by the receiver against the beneficiaries on the grounds that the participant had retroactively lost the right to dispose of its assets. Consequently, these payments – not invalidated as such “in the system” – would be null and void or non-binding and, therefore, subject to restitution “outside the system”.

Such a narrow interpretation would be particularly shocking as it would actually go directly against the spirit and the text of the Directive which aims precisely at avoiding, for example, the application of such a zero hour rule or the invalidation of a netting or a transfer order (see Articles 3, 5 and 7). Furthermore, a recital cannot overrule or contradict the provisions of a directive.

Member States are responsible for ensuring that the implementation into their national legislation leaves no room whatever for doubt as regards the protection granted to transfer orders executed in their systems.

Article 8 of the Directive is a conflict of laws rule stating, in substance, that in the event of the insolvency of a participant in a system, the effect of the insolvency proceedings on the rights and obligations of such participant arising from, or in connection with, its participation in a system will be determined by the law of the jurisdiction which governs the system. Such a rule, in spite of a slightly different formulation, is close to the one stipulated by Article 9.1 of the Insolvency Regulation (see paragraph 12 above).

First of all, this provision is important as it determines by reference to the law of the system the rights and obligations of an insolvent participant for matters which are not specifically covered elsewhere in the Directive. One can refer, for example, to a transfer of contracts or of positions organised by the relevant system, in accordance with local law.

Secondly, and most importantly, Article 8 sets out a conflict of laws rule (for the EU judge) by stating that, in the event of insolvency proceedings being opened against a defaulting participant (incorporated in the EU or not) in an EU system, the participant's rights and obligations toward the system for matters governed by the Directive (transfers orders, netting, irrevocability, zero hour, etc.) will be determined by the law governing

⁶⁸ The well known issue of undue payments or payments erroneously transferred to a wrong beneficiary.

⁶⁹ The well known issue of fraudulent payments made particularly in infringement of the rules concerning a “suspect period” or immediately prior to the day of insolvency.

⁷⁰ See the words “for example” contained in Recital 13.

that system and not by the insolvency law of the defaulting participant. In other words, additional conditions under legislation in the insolvent participant's jurisdiction regarding netting, irrevocability of payments or the effects of the insolvency decision, will not apply if they differ from the conditions of the law of the system (see also paragraph 12 above).

The same should apply to the exclusion of a “zero hour” rule contained in the insolvency law applicable to a foreign participant to a system: it is the law governing the system – including its rules on the “finality” of payments in the case of the insolvency of the participant – which will exclusively govern the validity of payments made via this system, as “rights and obligations arising from the participation (of the insolvent party)” in the system in question.

Section IV of the Directive, consisting of Article 9, is specifically devoted to the insulation of rights with respect to collateral security granted to a participant or a central bank of a Member State (“collateral taker”), in the event of the insolvency of the collateral provider⁷¹.

Article 2(m) defines “**collateral security**” as “*all realisable assets provided under a pledge ..., a repurchase or similar agreement, or otherwise*⁷², for the purpose of securing rights and obligations potentially arising in connection with a system, or provided to central banks of the Member States or to the (future) European Central Bank”.

There is a need to differentiate here between, on the one hand, the actual insulation of the collateral security against the insolvency of the debtor, which is the goal of Article 9.1 of the Directive, and, on the other hand, the determination of the law applicable to collateral on book-entry securities recorded in an account, as laid down in Article 9.2.

a. Insulation of “collateral security” against insolvency of the collateral provider

The aim of Article 9.1 of the Directive is twofold.

Its first goal is to protect the holders of “collateral security” in relation to participation in a payment or securities settlement system against the negative effects of the law governing the insolvency of a foreign participant (whether or not originating from the EU). This is the issue described above in Section I above (see paragraph 4 and following).

The second objective of Article 9.1 is to ensure the legal effectiveness of “collateral security”, to the extent that it will not be “affected by insolvency proceedings” against the debtor, whether it is a foreign or even domestic insolvency proceeding. The Directive adopts the rule introduced in the Insolvency Regulation (Article 5.1), which allows the collateral taker to realise its collateral without being “affected” by the opening of the

⁷¹ On the legal protection offered to collateral by the Euroclear system already before the implementation of the Directive, see L. De Ghenghi and B. Servaes “Collateral held in the Euroclear System: a legal overview”, *Journal of International Banking and Financial Law*, March 1999, p.83; see also my study on the protection granted by Belgian financial law (“Protection juridique des systèmes de paiement et de règlement-titres en Belgique”) in *Revue de la Banque* 2000, p.313 to 326.

⁷² This expression more generally aims at covering any other type of security interest legally recognised in a Member State, such as, for example, statutory liens on specific assets or transfers of ownership for security purposes (“transfer of title”) (see in this sense, Recital 9).

debtor's insolvency⁷³. The Directive goes even further than the Insolvency Regulation to the extent that a collateral taker will not be affected by the opening of an insolvency, even if the assets provided as collateral (a pledge for example) are located in the same Member State as the one where the insolvency proceedings have been opened (by contrast, the Insolvency Regulation (or the 'Winding-up' Directives) supposes that the pledged assets, to benefit from the "non-affected" rule, must be located in a Member State other than the country where the insolvency proceedings have been opened). The creditor may, under this hypothesis, realise the collateral as if insolvency proceedings would have simply not been opened, without being bound by the restrictive domestic rules applicable to the realisation of collateral in the case of insolvency. This is also the solution adopted in the Collateral Directive (see Articles 4 and 9).

In other words, supposing the insolvency of a participant is governed by the same national law as the one governing the system itself, Article 9.1 means that the collateral taker can realise its collateral (also located in the same jurisdiction) without having to obtain the prior authorisation of the receiver or of the competent court, should the national law require this in the case of insolvency of the collateral provider. But it goes without saying that the collateral taker must always, however, comply with the rules applicable under the general law applicable to collateral with respect to the procedures of realisation of its collateral (for example, the necessity to sell in an organised market, or at the best possible price, etc; on a similar rule, see Article 4.6 of the Collateral Directive).

The same rule (second indent of Article 9.1) also applies to collateral provided to central banks of Member States (or to the European Central Bank) by their counterparties, without there being any requirement to have any connection whatever with "a system"⁷⁴ or that the counterparty should have the quality of "participant" in the sense of the Directive. The idea is to apply the insulating rule of Article 9.1 to all collateral security transactions of central banks acting in this capacity (see Recital 10) – which covers monetary policy transactions, interventions on exchange markets or transactions linked to the management of their external reserves – whether the secured transaction is formally carried out or processed in a system or not. The same extension is offered for the relations between financial institutions or between financial institutions and their clients in the context of the Collateral Directive (see Article 1.2 (e) and 1.3; see below).

b. Determination of the law applicable to collateral security on book-entry securities

⁷³ On the scope of this rule, see above paragraphs 9 and 10 as well as paragraph 16. As mentioned in paragraph 17, this is also the solution finally adopted in the Directives on reorganisation and winding-up of credit institutions and insurance undertakings.

⁷⁴ Contrary to collateral security in favour of a participant which must be provided "in connection with a system" by another participant, becoming insolvent (first section of Article 9.1). One will note that Article 2 m of the Directive, concerns the definition of "collateral security", also refers to the security of "rights and obligations potentially arising in connection with a system" without any further explanation. What is surely being intended here, is, first, to catch collateral security provided in favour of the system operator, but also all collateral security provided "in connection with a system" (see Article 9.1 and 9.2) "in favour of a participant", whoever that participant may be. Article 9 applies therefore to collateral security provided in a system, to participants in that system. We consider in this respect that the EU Commission's Explanatory Memorandum of the initial draft Collateral Directive, to the extent it seems to imply that the Settlement Finality Directive, as well as the other EU legal acts described above, would not apply to collateral between participants (section 1.2, second and fifth paragraphs) but only to central banks and operators of systems, is incorrect.

The aim of Article 9.2 of the Directive is to determine the law applicable to collateral provided in the form of book-entry records that represent securities accounts or rights in securities (this is the case of “physical” securities circulating by way of book-entry transfers or dematerialised securities solely represented by book-entry records on accounts etc.). This issue of applicable law is particularly crucial and complex, especially when securities are held on account with a financial institution in one country and then held through a chain of intermediaries, with a custodian in another country which itself then holds such securities with the central securities depository system where the underlying securities have been directly issued and are primarily held.⁷⁵

Should the law of the country where the underlying securities are issued, or at least where the underlying certificates are ultimately held, be applied, or should one apply the law of the country where the interest in the book-entry securities held on an account is recorded with an intermediary? Article 9.2 of the Directive opts for this second solution, which has been recommended for several years by several international financial market associations.⁷⁶ This is also the approach proposed by the Collateral Directive (Article 9) by reference to the place of the relevant intermediary (the one maintaining the account where the collateralised assets are recorded). This rule (PRIMA) is also proposed (with however a refined connecting factor referring no longer to the place of the account but, as a rule, to the law governing the account agreement) at the international level by the Hague Conference on Private International Law in its Convention on the law applicable to certain rights in respect of securities held with an intermediary⁷⁷.

Article 9.2 of the Settlement Finality Directive thus aims at ensuring that if a participant (or a central bank of a Member State) holds securities as collateral security in a register or an account⁷⁸ held with an intermediary situated in a Member State, its rights as

⁷⁵ This is the daily management of securities held with international central securities depositories systems such as Euroclear or Clearstream for example. One may also think of the case of links between national central securities depositories; on Article 9.2, see Richard Potok, “Legal certainty for securities held as collateral” in *International Financial Law Review*, Dec. 1999, p12; see also “The Oxford Colloquium on Collateral and Conflict of laws” held at St John’s College (Oxford Univ.), *Journal of International Banking and Financial Law*, September 1998 (Butterworths).

⁷⁶ See in particular the booklet entitled “Modernising Securities Ownership, Transfer and Pledging Laws” of Randall D. GUYNN, published in 1996 by the Capital Markets Forum (Section on Business Law of the International Bar Association); for further details on this problem, see also the Explanatory Memorandum of Belgian law of 28 April 1999 implementing the Directive, Doc. Chambre, session 1998-1999, n° 1999/1, pp. 23 and 24.

⁷⁷ See the preparatory report of the Hague Convention prepared by Christophe Bernasconi as First Secretary at the Hague Conference’s Permanent Bureau, available on the website of the Hague Conference (www.hcch.net) ; see R. Potok, “The Hague Conference...”, *JIBFL* 2001,p.166 (see footnote 15).

⁷⁹ Or at a centralised deposit system.

⁷⁸ See in this respect, Article 8.2 of the Belgian Act dated 28 April 1999 implementing the “Finality Directive” in Belgium (*Moniteur Belge*, 1 June 1999, 19563); see our study on this Belgian law in “*Revue de la Banque*” 2000, p. 313.

collateral taker will be governed by the law of the Member State where the register or account (recording the provision of collateral)⁷⁹ is held⁸⁰⁸¹.

As “local law” (the law of jurisdiction where the relevant assets subject to collateral are located), the law of the intermediary maintaining the collateral account will govern the nature of the rights of the collateral taker on the securities, the enforceability vis-à-vis third parties (“perfection” governed by *lex rei sitae*) and the realisation rules (see also Article 9.2 of the Collateral Directive).

Article 9.2 of SFD appears to be designed for collateral security in the form of book-entry securities, taking the form of a **pledge** for example. In the case of secured transactions in the form of a **repo**, this rule should mean, in our opinion, that the validity and enforceability as against third parties of the transfer of ownership (with respect to the book-entry securities) will be governed by the law of the Member State where the interests representing the securities transferred are recorded, without prejudice to the application of the law governing the transaction itself (applicable as “*lex contractus*”) with respect to the counterparts’ various contractual obligations (in that sense, WUD : Article 26, see above n° 16 and footnote 39).

The implementation of the Directive into domestic law was due by 11 December 1999 (Article 12). All EU (and EEA) countries have implemented the Directive into their national laws, even though most EU countries seem to have followed in some cases a narrow interpretation of the Directive (in particular with respect to Article 9 by restricting its application at national level to collateral constituted in favour of a central bank or of the system’s operator but not to collateral between participants).

As a follow-up of the SFD, we have now to comment on the specific provisions of the so-called “Collateral Directive” of 6 June 2002 which is the subject matter of the following section.

V. THE DIRECTIVE 2002/47/EC ON FINANCIAL COLLATERAL ARRANGEMENTS OF 6 JUNE 2002

The importance of collateral transactions for the smooth and efficient functioning of domestic and international financial markets is pretty obvious nowadays. According to the preparatory report prepared by the EU Commission on 15 June 2000⁸²:

⁷⁹ See in this respect, Article 8.2 of the Belgian Act dated 28 April 1999 implementing the “Finality Directive” in Belgium (*Moniteur Belge*, 1 June 1999, 19563); see our study on this Belgian law in “*Revue de la Banque*” 2000, p. 313.

⁸⁰ See, however, Recital 21 of the Directive which seems to reserve, in fairly sibylline terms, the application of the law of the Member State where the securities are issued or in which they are originally located as regards the basic regime applicable to these securities.

⁸¹ Which is the jurisdiction where the intermediary holding the relevant account is located.

⁸² “Working document on Collateral from the Commission to relevant bodies for consultation”, C4/PN D (2000)

- As of the beginning of 1999, the total value of government securities on loan or repo in the majority of the EU countries was estimated at \$900 billion. The size of the market in the US was approximately twice as large.
- An ISDA83 collateral survey concerning the size and complexity of the market for collateralised OTC derivatives estimated that the value of the collateral held in the OTC derivatives market as of the end of 1999 amounted to approximately \$250 billion.
- At the beginning of 2000, the European Central Bank held collateral of around €550 billion of which nearly €160 billion was held on a cross-border basis.

Collateral under the form of pledge or transfer of title arrangements are used by financial institutions, “corporates” (major commercial companies active on the financial markets), central banks and other financial public entities for trading, investment and financing purposes, as a way to manage properly their credit risk on counterparts and the market risks on the various assets subject to such collateral transactions, especially if the use of collateral⁸⁴ can lead to regulatory (“Basle ratios”) and tax/accounting favourable treatment (neutralisation of any capital gain or accrued income deriving from a transfer of assets in favour of the collateral taker that has to transfer back the assets once reimbursed at the end of the transaction).

It is therefore paramount to use collateral techniques that benefit from robust legal protection, in order to allow the collateral taker to recover in case of default (in particular in insolvency situations) the amount of its exposures on the defaulted counterpart. Such legal soundness is generally required by banking regulators for capital adequacy purposes⁸⁵, but is also of course strictly necessary from a risks management and audit viewpoint, and carefully monitored by rating agencies as part of their credit assessment of the relevant institution acting as collateral taker.

Collateral instruments must therefore be valid and binding between parties, enforceable (or good) against third parties and the assets so provided must be easily and rapidly realised (by way of sale or appropriation or by way of set-off in the case of claims) notwithstanding any insolvency proceedings affecting the collateral provider.

As a reminder, this legal robustness should not only be ensured at **domestic level** (assuming that both collateral taker and collateral provider would be situated in the same country, dealing domestically without any cross-border aspects) **but also at cross-border level** for transactions between institutions from different countries making a collateral transaction under an agreement governed by the law of another jurisdiction

⁸³ International Swaps and Derivatives Association, Inc.

⁸⁴ We will use hereafter the term « Collateral » to cover the type of transaction (pledge, repo, transfer of title, margins, etc) rather than the assets subject to the security arrangement, unless otherwise required by the commented provision.

⁸⁵ See the EU Directive 96/10/EC of 21 March 1996 amending Directive 89/647/EEC as regards recognition of contractual netting by the competent authorities, OJ L 85, 3.4.1996, 17) in particular the revised Annex II, Article 3 (b), (ii) and (iii).

related to assets “located”⁸⁶ or held with an intermediary (CSD, ICSD, global custodian, local agent/custodian) operating in a fourth country. In such a case, the collateral taker will have to take into account the regime of at least **three different laws** to assess the legal soundness of his transaction:

- The law governing the collateral agreement (“lex contractus”), generally the law explicitly selected by the parties, according to the Rome Convention (in the E. U.) and to basic principles of conflict of laws of most countries, as regards the validity and the binding character of the agreement between parties, which will govern the contractual aspects of their collateral arrangements (type of collateral, contractual duties to create the security interest, or to make the transfer of assets for security purposes, valuation, margins requirements, close-out provisions in case of default, etc);
- The law governing the proprietary aspects of such collateral transaction (being, in case of a security interest in the form of a pledge, the formalities to create a “right in rem” of the type agreed by the parties, giving a preferential right over unsecured creditors on the proceeds of the pledged assets, and in the case of a transfer of title, the way to transfer the ownership of the assets as agreed by the parties), including the formalities required, if any, to perfect⁸⁷ the collateral in order to make it enforceable against third parties. Such law will be determined, generally pursuant to the “lex rei sitae” (or “lex situs” in the Anglo-Saxon terminology), by reference to the local law where the assets pledged or transferred are “located”. This law will also govern the realisation of the assets that are the subject matter of the collateral.
- The law governing the possible insolvency – whether under the form of a reorganisation (aiming at restoring the financial soundness of the debtor) or of a bankruptcy proceedings (aiming at liquidating the assets of the debtor) – of the collateral provider that will generally be determined by reference to the law of the country where the head/main office of the insolvent debtor is situated but local insolvency proceedings may also be opened in other countries where the insolvent collateral provider may have branches or assets⁸⁸. Such insolvency law(s) may affect the collateral, e.g., either by invalidating the collateral arrangement as constituting a preference (or a fraudulent conveyance) if made during a certain period before the bankruptcy order, or by freezing any foreclosure or realisation of the assets during a certain period after insolvency that will be subject to prior authorisation of the receiver (“stay”), or by subordinating the preferential claim of the collateral taker to other special

⁸⁶ The underlying securities related to the book-entry collateral transaction may also be held/located in other countries (where they have been initially issued and deposited) via sub-custodians (home CSD, local depositories) which is common practice in cross-border securities business.

⁸⁷ Perfection is broadly equivalent to the French concept “opposabilité aux tiers”.

⁸⁸ See Richard Obank, *Outlining Insolvency Practice in Europe*, *Journal of International Banking and Financial Law*, 1999, p. 437; *Insolvency Restructuring 2002* (Law Business Research), “International cases” sections; Philip Wood, *Principles of International Insolvency*, Sweet & Maxwell (1995), n° 5-17; see also n°13-1, p. 237 and following.

classes of preferred creditors (employees, tax or social authorities, etc) downgrading as a result the expected ranking of the collateral taker.⁸⁹

With regard to these cross-border aspects of collateral transactions, we have reviewed above⁹⁰ the European legal context already in place for achieving legal certainty for collateral (especially in case of insolvency of the collateral provider) which consists in particular of the Directive 98/26/EC of 19 May 1998 on settlement finality in payment and securities settlement systems⁹¹ (in particular Article 9; "SFD") as well as of Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding -up of credit institutions⁹² (in particular Articles 21, 23-27; "WUD"), the Directive 2001/17/EC of 19 March 2001 on the re-organisation and winding-up of insurance undertakings⁹³ and the Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings⁹⁴ (in particular Articles 5, 6 and 9), (about this legal framework, see also the fourth recital of the Collateral Directive).

With respect to the **substantive** rules governing collateral transactions once being determined by application of the conflict of laws rules, without application of foreign insolvency laws of the collateral provider (having regard to the above-mentioned EU legal instruments), it is worth mentioning that since the beginning of the 90ies, most OECD countries started a general review of their domestic financial laws, generally under the pressure of G-10 or EU bodies⁹⁵ or of their national market players, in order to improve their collateral regime on the different aspects mentioned above. This trend was enhanced with the establishment of the European Central Bank in 1998 (in fact already since 1995/1996 with the former European Monetary Institute) which wanted to ensure

⁸⁹ On this distinction, see Joanna Benjamin, *The Law of Global Custody*, Butterworths 1996, chapters 6 and 7, p. 49 and following; see also Richard Potok, "Cross-Border Collateral: Legal Risks and the Conflict of Laws", Butterworths 2002. All the various national reports in this last book are based on the same collateral fact pattern (covering both a pledge and transfer of title arrangement).

⁹⁰ See also D. Devos, "La directive européenne 98/26/CE concernant le caractère définitif du règlement dans les systèmes de paiement et de règlement des opérations sur titres", *Euredia* 1999, p. 149 et suivantes; « Collateral transactions in Payment and Securities Settlement Systems: the EU framework » in *Revue de Droit bancaire et financier*, 2002, pages 10-27; « The European Directive of 19 May 1998 on Settlement Finality in Payment and Securities Settlement Systems » in *Capital Markets in the Age of the Euro*, Editors Prof. Ferrarini, Hopt, Wymeersch, Kluwer Law International 2002, p. 361-388.

⁹¹ OJ L 166, 11.6.1998, p. 45.

⁹² OJ L 125, 5.5.2001, p. 15; on the WUD, see in particular Jean-Pierre Deguée, "La directive 2001/24/CE sur l'assainissement et la liquidation des établissements de crédit: une solution aux défaillances bancaires internationales?", *Euredia* 2002, p.241.

⁹³ OJ L 110, 20.4.2001, p. 28.

⁹⁴ OJ L 160, 30.6.2000, p. 1. This Regulation entered into force on 31 May 2002.

⁹⁵ The so-called Lamfalussy Report: "Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries (BIS, November 1990); Report from the Committee on Payment and Settlement Systems "Cross-border Securities Settlements" (BIS, 1995); Standards on the use of securities settlement systems for the purposes of ESCB monetary policy transactions (EMI, 1998), etc. On this influence of international standards set by regulatory bodies, see Mario Giovanoli, "A new architecture for the global financial market: legal aspects of international financial standard setting", in *International Monetary Law, Issues for the new millennium* (edited by M. Giovanoli), p.3 and following.

that an adequate legal framework was in place in the EU for the development of ESCB monetary policy transactions as of January 1999.

But in spite of such continuous improvements at domestic level, the collateral regime of several EU countries remains still either unfavourable to the extent that domestic laws would leave open some risks of re-characterisation of a repurchase transaction or transfer of title into an irregular unenforceable pledge or would still establish undue constraints on the establishment, the use, the perfection of a pledge (filing, registration, etc), or on its realisation (stay, judicial authorisation). Netting of claims by way of novation or set-off may also in some countries be void after insolvency. In addition, negative impacts of suspect period rules (in insolvency situations) may still endanger the validity of collateral transactions made in a pre-insolvency period.

This situation has led the EU Commission to create in Autumn 1999 a working Party ("Forum Group on Collateral") that contributed substantially to the definition of the industry's needs in terms of legal certainty for collateral transactions and proposed a draft directive, under the impulsion of Mr. Guy Morton and Richard Potok, well known in this area.⁹⁶

Finally, after consultation process, the EU Commission presented on 27 March 2001⁹⁷ a proposal for an EU Directive on financial collateral arrangements.

This proposal of Directive was intensively discussed under Swedish and more especially Belgian EU Council's presidencies, that succeeded in reaching a Common position at the Brussels ECOFIN of 13 December 2001 (only 9 months after the initial proposal which is indeed a remarkable fast birth giving not so frequent in EU legislative matters). After a quick and constructive co-decision process with the EU Parliament during the first half of 2002, the Directive was adopted in final form on 6 June 2002.⁹⁸

The present section aims at commenting on the provisions of the EU Directive 2002/47/EC on Financial Collateral Arrangements (hereafter "the Directive")⁹⁹ to

⁹⁶ See the various position papers produced by members of the Forum Group attached to the Working Document on Collateral (containing a first draft Directive prepared by the Commission on the basis of the draft made by the Forum group) circulated to Members States and to market participants in the course of a consultation organised on 15 June 2000. See also attached to this consultation the converging report prepared by a special working group (with market lawyers) established by the ECB.

⁹⁷ OJ, C 180 E, 26.6.2001, p.312 with an explanatory memorandum. This memorandum contained however several statements concerning the interpretation of the 1998 Settlement Finality Directive (second and third paragraphs of section 1.2) to which we can not subscribe since it contradicted this last Directive itself by giving a narrow scope of application that was however not favoured by the services of the Commission themselves (on this discussion, see our study on "Collateral Transactions.." in *Revue de droit bancaire et financier*, 2002, p. 26 n° 37, footnote 73).

⁹⁸ OJ L 168, 27.6.2002, p.43.

⁹⁹ See also Spyros Economou, « La proposition de directive européenne sur les contrats de garantie financière », *Bull. Joly Bourse*, 2002, chron., 1; Clifford Chance, *Securities Newsletter* May/June 2002; Dermot Turing, "The EU Collateral Directive", *Journal of International Banking and Financial Law*, 2002, 187 G. MORTON, « Modernization of EU financial law : the directive on financial collateral arrangements », *Euredia*, 2003/1, p. 11 ; H. SEELDRAYERS, « De Europese Richtlijn inzake zekerheidsovereenkomsten – Krachtlijnen en artikelsgewijze commentaar », *T.Fin.R.*, 2003-1, p. 337 et 2003-2, p. 420 ; F. T'KINT et W. DERIJCKE, « La directive 2002/47/CE concernant les contrats de garantie financière au regard des principes généraux du droit des sûretés », *Euredia*, 2003/1, p. 41 ; H. DE VAUPLANE et J.-J. DAIGRE, « Chronique financière et

understand their rationale, already pretty well described in the detailed recitals of the Directive that looks sometimes like a kind of “User Guide”¹⁰⁰ as some provisions of the Directive¹⁰¹. Needless to specify that our aim should be to provide a first commentary of the Directive rather than to review it in detail at the light of a comparative law survey¹⁰².

We will review the scope of the Directive (I), the removal of collateral formalities (II), the pledge’s provisions (III), the transfer of title’s provisions (IV), the provisions common to both collateral instruments (V), the applicable law (VI) to finally conclude on the foreseeable achievements of the Directive (VII).

1. *The scope of the Directive*

The scope of the Directive was probably amongst the most sensitive topics during the consultation process and discussions at the EU legislative-making level.

Indeed, if almost all Members States representatives were of the opinion that the Directive was necessary to remove remaining legal risks from substantive laws within the EU for the benefit of financial markets and transactions, there were diverging views with respect to the assets to be covered and more importantly about the type of counterpart qualifying as protected collateral taker and collateral provider under the Directive.

a. Relevant types of collateral instruments

Pursuant to Article 1.1, the Directive applies to “financial collateral arrangements” (hereafter “Collateral”) that take the form of either a “security financial collateral arrangement” or a “title transfer financial collateral arrangement” as defined in Article 2.1.

This covers basically any type of **contractual**¹⁰³ **security interest** (especially a **pledge**), where the collateral provider remains the owner of the pledged assets transferred as security to the collateral taker, and **transfer of title for security purposes** (including in particular repurchase transactions), where assets are transferred (against others) in full

boursière », *Banque & Droit*, mai-juin 2003, p. 30, spéc. p. 38 ; W. BOSSU, « De Richtlijn betreffende financiëlezekerheidsovereenkomsten : inhoudelijke analyse », in *Sûretés bancaires et financières – Bancaire en financiële zekerheden*, M. Tison (ed.), Série: Cahiers AEDBF/EVBFR-Belgium n° 15, Bruxelles, Bruylant, 2004, p. 227.

¹⁰⁰ See for example recital 14.

¹⁰¹ See Article 2.1 (n) on the definition of “close-out netting provision” that is inspired by Section 10 of the 1995 GMRA (“Global Master Repurchase Agreement”) on repo transaction elaborated by ISMA (compare with the same provision in the 2000 version of the same GMRA); on the PSA/ISMA GMRA, see G.Morton in “Cross-Border Securities (Repo, Lending and Collateralisation)”, edited by Tyson-Quah, FT Law & Tax, p.31.

¹⁰² See however already the remarkable study of JP Degué, already quoted above, in Euredia 2002 that contains elements of comparative law on collateral-related matters.

¹⁰³ Excluding therefore security interest only created by operation of law like statutory liens that are however also used in some jurisdictions as collateral technique by financial institutions and operators of payment and settlement systems.

ownership but with the duty to retrocede equivalent assets at the maturity of the transaction.¹⁰⁴ Additional constitution of collateral by way of **margins calls** (“top-up collateral” aiming at marking-to-market the value of the assets to cover both parties against any market risk deriving from changes in the market value of the assets) is also protected (see in particular Article 8.3).

b. Relevant assets

The Directive applies to Collateral relating to cash or financial instruments (Article 1.4 (a)).

By cash, the Directive is referring to cash credited to an account (Article 2.1 (d)) which means that as usual in most countries, the subject of a pledge of cash will be the claim in reimbursement against the institution holding the cash account, since the cash itself will become the property of the intermediary as a result of the fungibility of cash deposits unless otherwise organised by the law governing the cash account. Banknotes as such are explicitly excluded according to Recital 18.

By financial instruments (hereafter “securities”), one means:

“Shares in companies and other securities equivalent to shares in companies and bonds and other forms of debt instruments if these are negotiable on the capital market, and any other securities which are normally dealt in and which give the right to acquire any such shares, bonds or other securities by subscription, purchase or exchange or which give rise to a cash settlement (excluding instruments of payment), including units in collective investment undertakings, money market instruments and claims relating to or rights in or in respect of any of the foregoing” (Article 2.1 (e)).

This is intending to cover all debt and equities instruments (including warrants, options and futures) plus the securities entitlement organised in some jurisdictions (like in Belgium, Luxembourg and the USA) giving to the holder of a securities account, not a direct and traceable property rights on the underlying securities held abroad via sub-custodians, but co-ownership rights on a pool of fungible securities (the co-ownership right does not apply directly on each of the underlying securities held on a fungible pooled basis but on the book-entry interests in securities as recorded in the books of the intermediary). In such systems, what is transferred or pledged is not the underlying securities but the co-ownership rights of the collateral provider on the pool of book-entry fungible securities vis-à-vis the intermediary holding the securities account. This is the sense of the term “*right in or in respect of any of the foregoing*”.¹⁰⁵

¹⁰⁴ On this type of collateral, see our study on “Protection juridique des systèmes de paiement et de règlement-titres en Belgique”, in *Revue de la Banque*, 2000, p. 318 and 319, n° 12; see our study on « Les effets externes des conventions en matière financière » in *Les contrats et les tiers*, (Ed. ABJE, Jeune Barreau de Bruxelles, Vlaams Pleitgenootschap bij de Balie te Brussel, 1995), p. 213 n° 18.

¹⁰⁵ One will find the same expression, aiming at encompassing explicitly the same type of securities entitlements, in Article 9.2 of the SFD (“rights in securities”), in Article 24 of the WUD (“other rights in such instruments”) and in the Hague Convention on the law applicable to certain rights in respect of securities held with an intermediary (Article 1.1 “any interest therein”, “rightsresulting from a credit of securities to a securities account; “interest in securities” in Article 2.1, d,e,f.). On this expression, see Johanna Benjamin, “Interests in securities”, Oxford University Press 2000 n° 1.05, 2.21 and following; J. Benjamin, “Conflicts of Law and Interests in Securities”, in “Cross-Border Securities (Repo, Lending and Collateralisation)” by K. Tyson-

Claims against the intermediary holding the securities account in question in relation to (actual or future) delivery of securities to be recorded on the account are also covered by the definition and may be subject to collateral arrangements under the Directive.

c. Type of protected counterparts

This was one of the most discussed topics since several countries, probably under the pressure of their ministry of Justice, did not want to extend the benefit of the protective regime of the Directive (derogatory to a major extent to usual collateral and insolvency regimes laid down in civil, commercial and insolvency legislation) to non-financial institutions (a fortiori not to natural persons) while others were more favourable to the inclusion of commercial companies active on financial markets, at least those having a certain size in terms of capital/own assets which could not be regarded necessarily as unequal when dealing with financial counterparts.

This last conception was proposed by the Commission in its initial proposal that included “person...whose capital base exceeds EUR 100 million or whose gross assets exceed EUR 1000 million at the time where financial collateral is actually delivered...” (Article 2.4 (c)). But the common determination of the financial base – and the thresholds- in relation to a specific collateral transaction was too complicated in view of the above divergence of approaches.

In order to reach an agreement on the Directive, a compromise was finally found on the following scope of the Directive (Article 1.2. (a) to (e)) including:

- All financial institutions (credit institutions, insurance undertakings, UCITS, investment firms, other financial institutions) under the meaning of applicable directives;
- Public bodies (Treasury agencies, financial institutions of public nature, etc), central banks, the ECB (plus the BIS, IMF, EIB, etc),
- Central counterpart in clearing systems (Clearnet, LCH, etc) and settlement agent or clearing house under the meaning of the Settlement Finality Directive (operators and transfer/paying agents in securities settlement systems designated by each Member State) and assimilated representatives (see Article 1.2 (d))
- And finally “a person other than a natural person¹⁰⁶, including unincorporated firms and partnerships, provided that the other party is an institution as defined [above].

Quah, F.T Law & Tax (1997), n° 2.3 and following, p.16; in the context of Belgian Royal Decree n° 62 of 1967 relating to book-entry circulation of securities, governing the rights of participants in the Euroclear system, see L. De Ghenghi and B. Servaes “Collateral held in the Euroclear System: a legal overview”, Journal of International Banking and Financial Law, March 1999, p.85-87; Bart Servaes, “Het immobiliseren van effecten: Het Belgisch juridisch kader” in “Nieuw vennootschap-en financieel recht 1999” (Jan Ronse Instituut-KU Leuven), p. 513. See also our commentary of Article 9, n° 62 below.

¹⁰⁶ One will note that some E.U. countries have implemented the Collateral Directive beyond its terms (based on the analysis that the Directive was setting up minimal harmonization rules) by applying the new collateral regime even to natural (“physical”) persons (see for example the Belgian Act dated 15 December 2004 relating to financial collateral; on this new law, see e.g. J.P. Deguée and D. Devos “La loi relative aux sûretés
(continued)

Commercial undertakings are therefore included as possible counterparts in financial collateral arrangements without requiring any minimal financial conditions. However, Article 1.3 reserves the faculty for a Member State to exclude from the scope of the Directive financial collateral arrangements where one of the parties is such a non-financial person, at the request of those countries that were opposed to such inclusion (on the consequences of such “opting-out”, see below in conclusions).

Subject to the above possible exclusion, the Directive will apply if both collateral provider and collateral taker(s) belong to the above categories (Article 1.2) being either both “financial institutions” or at least one “financial” institution dealing with one non-financial legal person (e.g. a company).

2. Removal of collateral formalities

One of the goal of the Directive is to simplify drastically the various formalities prescribed by some national legislations, especially in pledging arrangements, for the creation or the validity of a pledge between parties (written agreement, delivery of the assets, certification by way of notarial/public registration), its perfection or enforceability against third parties (delivery of the pledged assets, notification, publicity by way of registration of the pledge agreement in a public register (“filing” as the one foreseen for example by Section 395 of UK Companies Act 1985) that can be required in the country where the assets are located and/or in the country of the incorporation of the collateral provider, etc) or even its admissibility as evidence (notarial document, stamp, deed).

To that end, Article 3 states that “Member States shall not require that the creation, validity, perfection, enforceability or admissibility in evidence of a financial collateral arrangement or the provision of financial collateral under a financial collateral arrangement be dependent on the performance of any formal act”. Recital 10 gives a non-exhaustive list of such formal acts¹⁰⁷.

This removal of external formalities relating to pledging and transfer of title arrangements does not mean however that financial Collateral can be established by mere oral agreement between collateral provider and collateral taker without any externalisation of their will to create such Collateral. There are indeed two types of mitigating factors that are foreseen by the Directive:

- a. There is still a practical need to deliver the assets subject to a pledge or a transfer of title to the collateral taker, either in its account or in an account held on behalf of both parties by a third party (who can be the operator of a settlement system or any other custodian) or even to keep the assets in the account of the collateral provider but as being pledged in favour of a collateral taker with adequate measures to block such assets to be taken by the intermediary holding the account. Otherwise the collateral taker would be in a situation where in case of default of the collateral provider, he might discover

financières du 15 décembre 2004- Lignes directrices”, Rev. Droit bancaire et financier, 2005, p. 155-163 and the following studies in the same publication).

¹⁰⁷ This recital 10 specifies that acts that are required for the transfer or the creation of a security interest on physical securities not held in book-entry form, like endorsement for security purposes of instruments to order (bills of exchange, etc) or registration of a pledge directly on registered securities in the issuer’ books, should not be regarded as such formal acts.

that his collateral has lost its object-and therefore its goal- because of the previous transfer of the assets to another party (assuming the good faith of the latter which should be usually the case, especially in the absence of any publicity measures) if no blocking measure was put in place.

This is why the Directive is only applicable to Collateral “once it has been provided” (Article 3.2; see also Article 1.5) which means once “delivered, transferred, held, registered or otherwise designated so as to be *in the possession or under the control* of the collateral taker or of a person acting on the collateral taker's behalf” (Article 2.2; see also recital 9). A typical example will be the usual practice of identification of the assets as being pledged through the use of designated pledged securities and cash accounts (in the name of the collateral taker or even in the name of the collateral provider as long as the assets posted in such pledged account can be blocked up to the amount of the guaranteed claim or exposure of the collateral taker) held with an intermediary (a bank, a settlement system).

A certain form of dispossession is therefore still required under the Directive (see also Recital 10) which should give some comfort to those jurisdictions that were either reluctant to remove completely collateral formalities and/or willing to preserve this traditional feature of pledging arrangement linked to their right in rem's nature implying as a rule dispossession (as in French or Belgian law).

- b. The second mitigating factor is the requirement of a written evidence for both the Collateral agreement (the Directive refers to “arrangement”, without defining what it means, which seems broader than just the pledge or transfer of title agreement but in practice one may wonder what it is intended to cover) and the provision (see a) above) of such collateral (Articles 1.5 and 3.2¹⁰⁸).

The Directive specifies that such evidence of the provision of collateral “must allow for the identification of the financial collateral to which it applies. For this purpose, it is sufficient to prove that the book entry securities [evidenced by entries in a register or account maintained by or on behalf of an intermediary: Article 2.1 (f)] provided as collateral have been credited to, or form a credit in, the relevant account [as defined under 2.1 (h); see below] and that the cash collateral has been credited to, or forms a credit in, a designated account” (Article 1.5, second paragraph).

The Directive adopts a modern approach by allowing to take into consideration book-entries evidenced “by electronic means and any durable medium” (Article 2.3) and more generally any evidence “legally equivalent” to written evidence (Article 3.2) that seems to refer to other admissible evidence (see in that sense Recital 11: “in any other legally enforceable manner” foreseen by the *lex contractus*) under some national legislations as in commercial matters, where a Court may discretionary appreciate

¹⁰⁸ One will find several times in these two provisions the requirement that arrangements and provision of the collateral must be evidenced in writing, duplication that appears more as a “credo” inserted to ease adoption process but this does not really seem justified from a legislative point of view...

(admitting all evidence means like tape recordings, etc) whether an obligation is established or not, including by way of testimony and assumptions.

3. Security Financial Collateral Arrangement (Pledging)

Two provisions are specifically addressing pledging arrangement: Article 5, establishing a right of use of the pledged assets by the collateral taker and Article 4 on the enforcement of such pledging arrangements.

a. Right of use (Article 5)

Such right of use (or re-use) on the side of the collateral taker (sometimes also known as “rehypothecation”, especially in the US practice) seems rather revolutionary for jurisdictions influenced by the French “Code Napoleon” to the extent that under these laws, a pledgee can not as a rule dispose in any manner of the pledged assets transferred to him (especially by using them in the course of another transaction with a third party) since this is not regarded as an admissible right for a collateral taker¹⁰⁹ who should instead take care of the assets still belonging to the debtor (acting as pledgor) who has consequently the right to recover them back upon payment of the secured claim of the pledgee. In case of infringement of such prohibition, the pledgee may even lose his rights as secured creditor on the re-used assets (“déchéance pour abus de jouissance”; see Article 2082 of Civil Code).

However, the practices on the international financial markets show that such right of use is very common among many market players (especially with US counterparts) who consider this latitude as a pre-requisite to mobilise efficiently their collateral portfolio instead of freezing it in the framework of “classical” pledges, in cases where for any reason¹¹⁰, transfer of title (implying by nature a transfer of full ownership with the associated right of re-use for the transferee) may not be available. The downside is of course that by allowing the use of the pledged assets by the collateral taker for the purposes of other transactions with third parties (outright sales, repo, margins, pledges, loans, etc), the initial collateral provider is exposed to a credit risk on its creditor since it would have no guarantee that once fully reimbursed, the collateral taker will be able to transfer back equivalent assets to those initially pledged and re-used in the meantime.

In order to give to European financial institutions the same flexibility than the one enjoyed already today by some market players, it was finally agreed to introduce such right of use for collateral taker in pledging arrangements under the following conditions:

- The terms of the collateral arrangement must of course provide for such right (Article 5.1);

¹⁰⁹ We should however point out that it is agreed, even in French law jurisdictions, that with the consent of the pledgor, a pledgee may of course validly use the pledged assets (De Page, *Traité de droit civil*, VI, n° 1088-B in fine); compare with the situation under English Law: J. Benjamin, “Interests in Securities”, Oxford University Press, n° 5.46 and following, also promoting the reform of English Law’s equitable rules traditionally restricting rehypothecation of collateral.

¹¹⁰ Reasons may be linked e.g. to tax, accounting, capital adequacy, risks management, legal risks considerations; see Dermot Turing, (2002) 5, JIBFL (188).

- The collateral taker must incur an obligation (which can then be set-off; see the following bullet point) to transfer equivalent collateral¹¹¹ (to the one he used) at the latest on the due date for the performance of the secured obligations (Article 5.2);
 - On that date, either the initial pledged assets will be replaced by equivalent assets, or the value of such assets in replacement due by the collateral taker (that were finally not be provided) will be set-off against the amount of the secured claim owed to it by the collateral provider, in order to give to the latter a certain protection against pledgee's default.
 - The equivalent collateral shall not give rise to a new pledge (that may be challenged as preference or by virtue of any suspect period rules) but instead will continue to be governed by the initial security financial collateral arrangement as having been provided at the same time as the initial collateral (Article 5.3);
 - Such right of use can no longer be sanctioned by a "déchéance" or any termination of the pledge or of the rights of the pledgee (Article 5.4);
 - Close-out netting in case of default should be allowed in order to give effect, if necessary, to the set-off laid down in Article 5.2, second paragraph (see third bullet point above).
- b. Enforcement of pledge arrangements (Article 4, paragraphs 1-4)

Contrary to the heading of the provision, the first four paragraphs of Article 4¹¹² aim at addressing enforcement only of *security* financial collateral arrangement (pledging) by imposing on Members States to ensure that in case of default of the collateral provider (defined by the concept of "enforcement event"¹¹³), the collateral taker shall be able to realise the assets pledged (in accordance with the terms of the collateral agreement) through one of the following methods:

- For securities, by way of sale or appropriation¹¹⁴ of the assets;
- For cash (and securities if any), by way of setting off the amount of cash (or the value of the securities) against the amount of the secured obligations due to the collateral taker (Article 4.2).

As we can see, appropriation of the assets is foreseen in addition to the classical way to enforce rights of a pledgee through the sale of the assets. This is also quite

¹¹¹ The term « collateral » here is used to refer to the assets and not to the legal form of the arrangement.

¹¹² The two last paragraphs are common to both pledge and transfer of title arrangements and will be addressed in the following section of this paper, for clarity sake.

¹¹³ "Enforcement event" means an event of default or any similar event as agreed between the parties on the occurrence of which, under the terms of a financial collateral arrangement or by operation of law (as it is organised, for example, in German law for transfer of title), the collateral taker is entitled to realise or appropriate financial collateral or a close-out netting provision comes into effect" (Article 2.1 (I)).

¹¹⁴ Appropriation is only possible if contractually foreseen including with respect to the valuation of the assets (Article 4.2).

revolutionary (as the right of use) for some jurisdictions (again generally those inspired by French civil law¹¹⁵) where traditionally, appropriation of the pledged assets by the pledgee is not allowed (it is even a public policy prohibition: see Article 2078 of Civil Code; Articles 4 and 10 of Belgian law relating to commercial pledge) since it is viewed as eluding the formal requirement to seek the prior authorisation of the competent Court before realising the assets – which is the normal rule – or, as an exception, by appropriating them¹¹⁶ again upon prior judicial authorisation. But such formal requirement to obtain prior judicial authorisation before any enforcement has been gradually removed in the collateral laws of most countries over the past ten years so that appropriation as such (already foreseen for transfer of title arrangements as a natural result of the transfer of the full ownership to the collateral taker/transferee) should not be regarded any more as conflicting with the key features of pledging arrangements, especially in the financial area.

It is again open to Member States that did not allow appropriation on the date of the Directive (27 June 2002) to refuse to implement in their legislation such appropriation mechanism for pledge arrangements and accordingly – which is more debatable in our view – not to recognise it when laid down in pledging arrangements governed by another law which would organise such technique (Article 4.3). This is another “opting-out” provision introduced for compromise’s sake.

All enforcement techniques (sale, appropriation and set-off) of pledging arrangements must take place in accordance with the terms of the pledge agreement, without being subject to any other external requirement (that would be laid down in national law) such as to give prior notice, to seek prior judicial authorisation (see above), to organise a public auction, or to observe a certain time period (Article 4.4), before realising the pledged assets in order to be paid on the proceeds (or as a result of the appropriation or of the set-off). As mentioned above, this simplification of the enforcement proceedings was already introduced in many European and US laws in the past few years and the objective is now to impose such simplified realisation proceedings within the EU, beyond the scope (most often narrowly interpreted by national authorities, which is incorrect in our view) of the Settlement Finality Directive focusing on designated systems and their participants. With the Collateral Directive, the aim is now to encompass all collateral transactions between financial institutions (and even with commercial companies, subject to EU Member States’ opting-out) whether or not made through a system (or, in the above incorrect narrow interpretation, in favour of the operator of the system).

4. Protection of Transfer of Title Arrangements (Article 6)

Article 6.1 states very simply that “Member States shall ensure that a title transfer financial collateral arrangement can take effect in accordance with its terms” which means that the validity of a transfer of title for security purposes can no longer be put in question through its re-characterisation by a Court into a pledge (see recital 13).

¹¹⁵ See Fabrice Leduc, « Le gage translatif de propriété: mythe ou réalité », RTD civ. 1995, 307, where the author concludes that pledge under French law can not lead to a transfer of ownership on the pledged assets in favour of the pledgee.

¹¹⁶ On this issue, see our above-mentioned study on Belgian regime protecting payment and settlement systems, Rev. Banque, 2000, p. 318 and 319, with the references quoted in the footnotes.

It is worth to remind that in the 80ties the validity of repurchase transaction (that is a spot sale of securities against cash coupled with the reversed forward sale transaction where the initial buyer re-sells in turn equivalent securities to the initial seller; hereafter “repo”) was challenged in the US¹¹⁷ because of the economic purposes of such transaction that may be regarded as a credit in cash secured by way of securities transferred as collateral (one could also see it as a loan of securities secured by cash) while from a legal point of view it is a sale implying a full transfer of ownership of the securities to the buyer (even if it is a transfer of ownership for security purposes). This economical approach is generally the one adopted from a tax and accounting viewpoints that tend to analyse the transaction as a secured credit, the securities remaining accounted as belonging to the seller which is also the beneficial owner of the income attributed during the lifecycle of the repo, unless otherwise agreed. Such analysis was then used to challenge the legal qualification of (double) sale to try to re-characterise the repo into a pledge (in view of its economic purpose) generally void or non-enforceable because of non-fulfilment of the formalities required for the creation or the perfection of such pledge (see above)¹¹⁸.

The same debate took place almost everywhere in Europe and generated a wave of legislative reforms in order to remove such legal risk of re-characterisation (that might happen under the insolvency law of the defaulting party or under the laws of the country where the transferred assets are located as *lex situs*) and to organise specifically the rights of the non-defaulting party in case of failure of the other party (right to sell the assets or to purchase equivalent securities, depending on the position of the non-defaulting party; right to keep definitely the assets as a result of the transfer of ownership; close-out netting of the reciprocal obligations by set-off)¹¹⁹. Outside “true” repo, there are other types of transfer of ownership for security purposes (called “transfer of title”) that face the same kind of legal risks and for which it was necessary to achieve legal certainty.

Article 6.2 is dealing with the hypothesis of a default of a counterpart (“enforcement event”) triggering the application of a close-out netting (which is a setting-off of all¹²⁰ the

¹¹⁷ See M. Stigum, *The repo and reverse market*, Dow-Jones-Irwin 1989, especially chapter 19 (drafted by L. Stremba), p. 333; on French law, see. Luvel-Jurgensen et Guéranger, “Le réméré, la pension et le prêt de titres”, *Banque* 1992, p. 144 and 246; P. de Lapasse, “Le nouveau régime juridique des opérations de pension”, *Bull. Banque de France* (n° 7) July 1994, page 67; A. Perrot, “Pension de titres et transfert de propriété”, *Rev. dr. bancaire* 1994, p. 252.

¹¹⁸ On this issue, see J. Benjamin, “Recharacterisation risk and conflict of laws”, *Journal of International Banking and Financial Law*, 1997, p.513 and its updated version in the *Oxford Colloquium on Collateral and Conflict of Laws* (same review, special supplement, 1998, p.29); Fentiman, “Cross-border securities collateral; Redefining recharacterisation risk”, *Oxford Colloquium*, 1998, p.38.

¹¹⁹ On this issue, see our above-mentioned study, *Rev. Banque* 2000, p. 318-319.

¹²⁰ By encompassing all the reciprocal exposures and claims, such close-out netting provisions aim at reducing the total credit risk on the failed counterpart to the minimal net amount, avoiding cherry-picking from the liquidator of the insolvent counterpart, that is the selection of the favourable contracts from a general creditors viewpoint (those in which the non-insolvent party is debtor)-which are maintained and for which performance is sought- to repudiate the others, unfavourable to the insolvent party and its creditors, for which the counterpart in such last contracts would only have then an unsecured claim to lodge in the insolvency proceedings. By setting-off in case of insolvency all the contracts (that are interrelated in practice, like swaps and/or repos and/or loans) without distinction, one avoids such unbalanced treatment. On netting, see P.R Wood, *English and International* (continued)

reciprocal obligations to deliver cash and securities, including assets provided as margins, to mitigate the exposure of the non-defaulting party vis-à-vis the party in default, organised to take place automatically (in case of bankruptcy) or upon notice). We wonder what in fact the specific purpose of such Article 6.2 may be in view of Article 7 dealing more extensively with close-out netting provisions in all collateral arrangements¹²¹.

5. Common Provisions applicable to both Pledge and Transfer of Title: close-out netting and insolvency (Article 4, paragraphs 5 and 6; Articles 7 and 8)

Article 7 aims at ensuring that close-out netting provisions, stipulated in pledge (especially for pledge on cash and for the right of use, see above) **and transfer of title** (for which it is the standard way to enforce the rights of the non-defaulting party; see Article 10 (c) of the 2000 BMA/ISMA Global Master Repurchase Agreement) **arrangements, may apply and will remain valid and enforceable** notwithstanding the opening of insolvency proceedings (reorganisation or bankruptcy) against one of the parties (Art. 7.1 (a)) or the occurrence of any competition between creditors imposing , in certain jurisdictions, an equality of treatment (pari passu ranking) (Art. 7.1 (b)).

Such close-out netting provisions must apply in accordance with their terms without being subject to external requirements such as a prior notice or the need to obtain prior approval from Courts (Article 7.2 referring to the formalities excluded by Article 4.4 in the context of pledge), unless otherwise agreed.

In the same vein, **Article 4.5 stipulates the same regime for financial collateral arrangements as a whole** (both pledge and transfer of title) which must take effect in accordance with their terms notwithstanding the opening of insolvency proceedings (reorganisation or bankruptcy) against one of the parties.

Article 4.6 also states that enforcement of rights (including close-out netting) of the collateral taker as organised under Articles 4, 5, 6 and 7 “shall be without prejudice to any requirements under national law to the effect that the realisation or valuation of financial collateral and the calculation of the relevant financial obligations **must be conducted in a commercially reasonable manner**” in order to allow for an ex post control by the Court on the manner by which the collateral taker enforced its rights (see recital 17) and to hold him liable for any abuse in the exercise of such rights (case of a massive sale of the relevant assets on a market which would generate a substantial decrease of their market value while it would have been possible – without major damage for the creditor – to proceed to such realisation in a progressive manner¹²²).

Set-off, Sweet & Maxwell (1989); same author, “Principles of Netting: A Comparative Law Study”, NIBE-Bank Juridische reeks (n° 20) 1994; see also our study “Le netting en droit belge”, Rev. Banque 1994, p. 162.

¹²¹ In addition, in a repo at least, not only the “collateral taker” but also the “collateral provider” may fail to transfer the due assets. Both failures should trigger a close-out mechanism but this is probably what was intending to mean Article 6.2 by referring only to the collateral taker since both parties have in fact the capacity of collateral taker, each for the assets transferred to him.

¹²² For an example, see Belgian Act of 2 January 1991 on public debt instruments, Article 8 organising a simplified realisation proceedings for pledge of dematerialised securities with the comments made in the Explanatory Memorandum of this provision as amended in 1996, Doc. Chambre, Session 1995-1996, 501/1, p. 7 et 8.

Article 8 is dealing with the neutralisation of certain insolvency rules (mainly if not only in a bankruptcy situation since the rules in question are generally not foreseen in reorganisation proceedings) to provide collateral arrangements (again both pledge and transfer of title) with more legal certainty and predictability.

First of all, Article 8.1 (a) is aiming at protecting both collateral agreement and subsequent provision of assets (constituting the pledge or achieving the transfer of ownership in transfer of title) against the rules of some insolvency regimes pursuant to which an insolvency decision is deemed to have retroactive legal effects from the first hour of the day of its pronouncement (the so-called “**zero hour**” rule).

As indicated earlier, “zero hour” rules result in the insolvent party being deemed to have lost its legal capacity from the first moment of the day on which the insolvency decision was handed down. Therefore, the transactions and payments carried out between the first hour of the day of insolvency and the moment when the decision declaring its insolvency was handed down, are void or voidable, and at least not enforceable against the receiver. In the UK for instance, certain transactions (“property dispositions”) may be avoided if they have been made between the introduction of a winding-up petition and the day when the final winding-up resolution is taken by the general assembly of creditors or shareholders as ratified by the Court¹²³. In the financial area, most countries where such zero hour still applies have enacted special legislation to exclude at least its application with respect to financial transactions (see also Article 7 of the Settlement Finality Directive) but some uncertainties were still remaining in certain jurisdictions.

It is now laid down in Article 8.1 (a) that such zero-hour rule can no longer invalidate the collateral agreement or provision entered into or made on the day of the insolvency but in the hours preceding the moment when the insolvency decision has been handed down. The same protection is extended by Article 8.2¹²⁴ to collateral agreement or provision entered into or made still on the day of the insolvency of one party but after the moment of the insolvency decision provided that the collateral taker can prove that he was not aware, nor should have been aware, of the commencement of such proceedings or measures. A same protective rule for parties acting in good faith was adopted in Article 3.1 second alinea¹²⁵ of the Settlement Finality Directive for payment orders and their settlement in payment and settlement systems.

The second important rule, also rather revolutionary (that has some precedent in the SFD, Article 3.2¹²⁶), is aiming at excluding the application of preferences rules or, in

¹²³ See Mark Evans, Recent and prospective developments in settlement, part 2 in *Journal of International Banking and Financial Law* 1999, p. 425 about the zero-hour rules in the UK (before the implementation of the SFD) and its impact on collateral provided in systems like Crest; on the impact of the new Insolvency Act 2000 concerning small companies on this UK insolvency regime, see M. French and H. Staniland, *The Insolvency Act 2000* in *Journal of International Banking and Financial Law*, 2001, p. 174.

¹²⁴ The French translation of 8.2 (in fact, of the whole Directive: see also e.g. recitals 8 and 9, Articles 2.2 and 9.2) could be improved (“... à la date....mais après l’ouverture...”).

¹²⁵ See also in that sense Article 157.2 of Belgian Banking Law of 22 March 1993 on zero-hour rule and close-out netting.

¹²⁶ “No law, regulation or practice on the setting aside of contracts and transactions concluded before the moment of the opening of insolvency proceedings, ..., shall lead to the unwinding of a netting.”

French law – oriented jurisdictions, the “suspect period” rules in order to avoid that collateral agreements or subsequent provisions of collateral may be declared invalid or unenforceable just because they would have been entered into or made in a certain period of time (six months, two years, etc...) preceding the insolvency order (Article 8.1.(b)). This type of protection is a major derogation to the normal insolvency regime of all Member States where, in order to protect the general creditors against any “last minute” attempt to defraud them, certain acts of the debtor are deemed to be fraudulent or detrimental to the general creditors and therefore are (automatically) void or voidable. Those types of preference rules (applicable by reference to certain acts if carried out during a certain period) will no longer apply to collateral arrangements or provisions (see Article 8.1 “collateral may not be declared invalid...**on the sole basis** that...”). But this does not remove fraudulent conveyances rules or other types of suspect period rules based on fraud (“Fraus pauliana”) that will continue to apply (see Article 8.4) provided that evidence of fraud is demonstrated. The broad wording of such provision may well appear as contradicting the rules laid down in the previous paragraphs of Article 8 but in order to give some sense to this Article, paragraph 4 should be read as reserving only suspect period rules that do not apply automatically and for which evidence of fraudulent intention is required; see in that sense recital 16).

The same protective regime against zero-hour and preference rules is made applicable to the provision of **additional collateral (margins)** in order to adapt constantly the contractual value of the collateralised assets to their current market value (marking-to-the-market) that takes place by providing -or delivering back to the collateral provider, if the market value would be higher than the agreed value- additional cash and/or securities (“top-up collateral”) (Article 8.3 (a)). The same also applies (Article 8.3.(b)) to **substitutions** of the initial assets by new ones (which may completely differ from the previous assets transferred as collateral) of substantially the same value (see the regime of margins and substitutions in Articles 4 and 8 of the 2000 GMRA for instance).

Article 8.3 (ii) is protecting specifically margins transfers and substitutions against the risk of being qualified as a new pledge (transfer of title generally does not give rise to the same issue unless it is first re-characterised into a pledge precisely) created during the suspect period to cover pre-existing claims which is generally void under certain insolvency legislations. This protection is still subject to fraud exception according to the interpretation we give to paragraph 4 of this Article 8.

6. Conflict of Laws (Article 9)

The aim of Article 9 of the Directive is to determine the law applicable to collateral provided in the form of book-entry securities recorded in securities accounts for the purposes of the *lex rei sitae* (or *lex situs*¹²⁷) rule (see above Section IV, introduction, on the distinctions to take into account in terms of applicable law to collateral transactions).

¹²⁷ See also Christoph Keller, “Die EG-Richtlinie 98/26 vom 19.5.1998 über die Wirksamkeit von Abrechnungen in Zahlungs-sowie Wertpapierliefer-und-abrechnungssystemen und ihre Umsetzung in Deutschland” in *Zeitschrift für Wirtschafts-und Bankrecht*, 2000 (26), 1269 and following, proposing the concept of “*lex conto sitae*” (even though we do not share the restrictive view suggested by the author for the application of Article 9.2 of the SFD; see p. 1274).

This issue of applicable law is particularly crucial and complex, especially when securities are held on account with a financial institution in one country and then held through a chain of intermediaries, with a custodian in another country which itself then holds such securities with the central securities depository system where the underlying securities have been directly issued and are primarily held.¹²⁸ In that context, one has also to take into account the type of entitlement that is granted on the basis of the intermediary's books to reflect such indirect holding of securities through sub-custodians and CSDs. Usually, in cross-border holdings, the securities accounts of the investor with its intermediary recording a deposit of foreign securities will represent not the underlying securities themselves¹²⁹ but a securities entitlement consisting in interests in the underlying securities¹³⁰ (or rights in such securities) that may be protected by law as giving to the investor a co-ownership right in a book-entry pool of fungible securities of the same kind than those recorded in the investor's account (see above n° 44 and footnote 105).

Should the law of the country where the underlying securities are issued, or at least where the underlying certificates are ultimately held, be applied, or should one apply instead the law of the country where the interest in the book-entry securities held on an account is recorded with an intermediary? As mentioned earlier (see page 30, n°37), Article 9.2 of the Settlement Finality Directive already opted for this second solution . This is also the approach chosen in Article 24 of the Directive of 4 April 2001 on the reorganisation and the winding-up of credit institutions¹³¹.

¹²⁸ This is the daily management of securities held with international central securities depositories systems such as Euroclear or Clearstream for example. Global custodians and certain custodians are also acting through the same holding pattern. One may also think of the case of links between national central securities depositories; see R. Guynn and N. Marchand, "Transfer of pledge of securities held through depositories" in "The law of cross-border securities transactions", Sweet & Maxwell (1999), p. 47; Richard Potok, "Legal certainty for securities held as collateral" in *International Financial Law Review*, Dec. 1999, p12; see also "The Oxford Colloquium on Collateral and Conflict of laws" held at St John's College (Oxford Univ.), *Journal of International Banking and Financial Law*, September 1998 (Butterworths).

¹²⁹ Such underlying securities may consist either in "physical" certificates safe kept in the vaults of a CSD or of a local custodian and circulating by way of book-entry transfers in the local CSD; or in registered securities, the title of which is noted in the issuer's books, circulating in the books of the local CSD through the intermediation of nominees (of the local CSD or of the intermediaries, in order to make the registered securities fungible for book-entry transfer purposes) that appear as the legal owners of such registered securities in the issuers' books, holding the securities in trust on behalf of beneficial owners which are the relevant intermediary's clients; or in dematerialised securities, solely represented by book-entry records on accounts held with the local CSD, etc.

¹³⁰ See Roy Goode, "Security Entitlements as Collateral and the Conflict of Laws", Oxford Colloquium 1998, Special supplement of *Journal of International Banking and Financial Law*, p.22, especially p. 25 and 26; see also J. Benjamin, *Interests in Securities*, n°1.05 and 2.21 and following (see also n° 14.02-14.27).

¹³¹ "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".

This is now the rule set by the Collateral Directive (Article 9) for *book-entry securities collateral* (see definition under Article 2.1 (g)) by reference to the law of the country¹³² in which the **relevant account is maintained**).

The relevant account is defined under Article 2.1 (h) as “the register or account – which may be maintained by the collateral taker – in which the entries are made by which that book entry securities collateral is provided to the collateral taker”, meaning the account where the assets (securities or rights in the securities) are recorded as being pledged or transferred (on the meaning of “provision of collateral” under the Directive, see above n° 48) which is not so far from what Article 9.2 of the Settlement Finality Directive already stated or implied.

Since Article 9 of the Collateral Directive was aiming at mirroring the latest draft Convention (available at the time of the works at the EU Council) of the Hague Conference, and since it appeared rapidly that the Collateral Directive was likely to be adopted before the finalisation of the works on the Hague Convention (see below), it was then decided by the EU Council¹³³ “...to establish the place of the relevant intermediary (PRIMA) principle in the Directive, without going into further details at this stage” with the intention “that, when the Conference has been finalised, Article 9 may have to be reviewed in the light of the outcome of the Convention”.

7. Conclusions on the Collateral Directive

The Collateral Directive is an important step forward in the realisation of a single harmonised European financial market since it has contributed following its implementation by Member states to improve substantially the legal framework of collateral transactions within the EU as a continuation of the notable progress already made in this field with the Settlement Finality Directive, the Directives on the reorganisation and winding-up of credit institutions and of insurance undertakings, and the Insolvency Regulation¹³⁴. The Collateral Directive improved in particular the substantive regime¹³⁵ of pledge and repurchase transactions (including for marking-to-market arrangements: margin calls, substitutions) and removed most of the legal risks (re-characterisation of transfer of title into an irregular unenforceable pledge) and undue constraints on the establishment or the perfection of a pledge (filing, registration, etc), or on its realisation (stay, judicial authorisation), which were still existing in some EU jurisdictions. In addition, the Collateral Directive is introducing some flexibility especially for the benefit of pledging arrangements by allowing the collateral taker to use the

¹³² Excluding however any rules of renvoi that may be applicable under the national law so determined (Article 9.1, last sentence), in order to avoid referring to another law that would apply a different solution which would undermine the legal certainty and predictability wished on this issue.

¹³³ Statement of the Council's reasons, Doc 5530/3/02 of 5 March 2002, p.12 and 13.

¹³⁴ See our study « Collateral transactions in Payment and Securities Settlement Systems: the EU framework » in *Droit bancaire et financier*, 2002, pages 10-27; JP Deguée, *La directive 2001/24/CE sur l'assainissement et la liquidation des établissements de credit..*, Euredia 2002, p.241.

¹³⁵ While the previous EU legal instruments mentioned were more focusing on conflict of laws aspects except the SFD that contains also substantive protection rules (for payment orders and settlement and for collateral) in the scope of designated systems.

pledged assets (while protecting at the same time the collateral provider against credit risk on the pledgee) and to appropriate them in case of default, features that were so far generally regarded as specific to transfer of title arrangements. By doing so, the Directive is erasing the differences between pledge and transfer of title and the reasons for opting for one technique instead of the other. One could wonder whether in the long run these two instruments in the financial area would not merge with each other.

This being said, the Collateral Directive may suffer from the (unavoidable) political compromise that helped to its fast adoption in terms of the various opting-out that allow some Member States not to implement in their national regime (or even not to recognise which is in our view unacceptable and probably contrary to the essence of an EU Directive, especially this one) the inclusion of non-financial companies or the appropriation regime in pledging arrangements. Such dual regimes will certainly penalise the market players of the jurisdictions that would not implement such rules but will also maintain a certain degree of complexity and legal uncertainty in the EU Collateral framework which is not desirable nor expected as a result of this Directive (see also the definition of the preferences rules that have to be disregarded for collateral arrangements and those which will continue to apply...).

The EU Commission will probably have to play its role by helping Member States to coordinate closely in the implementation process to make sure things will evolve in the right direction¹³⁶. Consistency with the implementation of the other EU instruments (SFD, WUD, and Insolvency Regulation) will also have to be taken into account as well as with other international conventions finalised or under negotiations (Hague Securities Convention, draft Unidroit Convention on intermediated securities).

VI. NEW DEVELOPMENTS RELATING TO CONFLICT OF LAWS AND HARMONISATION OF SECURITIES LEGISLATION RELEVANT TO PAYMENT AND SECURITIES SETTLEMENT SYSTEMS

Since 2002, initiatives have been taken at international level to enhance legal certainty for transactions on book-entry securities, in terms of applicable law (the finalisation of the Hague Securities Convention end 2002) or with respect to their substantive regime (Unidroit – EU Legal Certainty Project).

1. *The Hague Securities Convention of 5 July 2006*

The “Hague Convention on the law applicable to certain rights in respect of securities held with an intermediary” (“the Hague Convention”), adopted by the 19th diplomatic session of the Hague Conference on Private International Law¹³⁷ on 13 December

¹³⁶ See Article 10 of the Directive relating to the establishment by the Commission of a report on its application by 27 December 2006 at the latest. A report is currently in preparation after a consultation process which ended on 31 March 2006 (see http://www.ec.europa.eu/internal_market/financial-markets/collateral/index_en.htm).

¹³⁷ The Hague Conference is an intergovernmental body established in 1955 to work on harmonisation of private international law (conflict of laws). It is based in the Hague (Netherlands) and has produced more than 35

2002, is aiming at providing greater legal certainty and predictability to the securities industry in relation to cross-border transactions on book-entry securities held through intermediaries.

This international Treaty has been elaborated during two years with the active support of public authorities, law practitioners, academics and industry representatives.

As one may know, a *subjective approach* (diverging from what has been adopted in the above EU instruments which refer to the jurisdiction in which the relevant account is held or maintained) has indeed been adopted in this Hague Securities Convention to determine the applicable law **by reference namely to the law selected to govern the account agreement** (or, if different from the custody law, by reference to the law agreed to govern proprietary aspects relating to book-entry securities) *provided that the intermediary in question has an office (e.g. a branch) in the country* (whose law is rendered applicable) engaged in securities accounts' business as defined (see Article 4.1 of the Convention).

Until now, as indicated above, there has been a considerable degree of legal uncertainty at international level in relation to the determination of the precise national law governing securities credited to an account with an intermediary in a cross-border dimension due to the variety of possible governing laws (law of the issuer, law of the place where the underlying certificates (paper certificates in bearer form) may be physically deposited or held, law of the register, law of the issuer CSD, law of another intermediary at upper or lower level, etc). This legal uncertainty generates in turn legal risks for the securities industry and the investors to the extent that the law governing the book-entry securities will determine the protection offered to the holder in case of insolvency of the intermediary as well as the formalities to comply with to create, perfect and enforce collateral arrangements on such securities. The application of another law than the one expected by the parties to the custody relationship might indeed jeopardise the ownership rights of the investor or invalidate its collateral transactions if the requirements of such other law would not have been fulfilled.

There have been ways to mitigate so far such legal risks (collection of legal opinions confirming the application of the intermediary's law under the laws of the country where the underlying securities are deposited and/or under the laws of the collateral provider, etc) but they remain, in a number of countries, still uncertain in case of judicial litigation. At EU level, some Directives (see above) have been enacted since 1998¹³⁸ with provisions helping to eliminate this uncertainty but these new rules, even though they are substantially increasing the level of legal certainty at EU level, remain limited to the EU without addressing the rest of the world (USA, Japan, Canada, Switzerland, China,

International Conventions on the law applicable to sales, trusts, judicial litigations, torts, agencies, but also family matters.

See the text of the Convention and the Explanatory Report prepared by Professors Goode, Kreuzer and Kanda with the assistance of Ch. Bernasconi, on the Hague conference website:

<http://www.hcch.net/e/conventions/menu36e.html>

¹³⁸ Settlement Finality Directive of 1998; Insolvency Regulation of 2000; Directives on the Reorganisation and the Winding-up of credit institutions and insurance undertakings of 2001; Collateral Directive of 2002.

etc), nor all the aspects of securities holdings, nor even all market players. This is what the Hague Convention is aiming at achieving.

This Convention was “technically”¹³⁹ signed end of 2002 by delegates of 53 States that are members of the Hague Conference, including e.g. the USA, the EU Member States, Japan, Australia, Argentina, Brazil, China and the Russian Federation.

The Hague Securities Convention has been recently signed jointly by the United States and Switzerland on 5 July 2006¹⁴⁰ and has officially become the “(Hague) Convention of 5 July 2006 on the law applicable to certain rights in respect of securities held with an intermediary”. It has now to be formally executed by one other government to enter into force (subject to applicable national ratification processes). In the EU, the Hague Convention’s adoption should imply amendments to some EU directives already adopted¹⁴¹. However, formal signing ceremony by the EU has been suspended in 2005 because of the opposition revealed since 2004 by some circles in the EU.

Certain EU Member States (essentially France, Spain, Italy, Sweden and Poland) and the European Central bank were opposed to the Hague because they argued that it could lead to more legal uncertainties (due to the greater flexibility offered by the Convention in the determination of the law governing the book-entry securities, by reference to the law agreed to govern the account agreement, instead of focusing on the place “where the account is (in fact) maintained”).

The EU Council decided in June 2005 to request the Commission to conduct an impact study on the Hague Convention (in relation to its scope, its impacts on third parties, securities settlement systems and public policy legislation). There has been quite an intense debate about the pros and the cons of the Hague Convention in 2005¹⁴² which might have contributed to this impact study which has been recently presented by the EU Commission on 3 July 2006 (“Legal assessment of certain aspects of the Hague Securities Convention”)¹⁴³. In a nutshell, the Commission staff is recommending to EU

¹³⁹ The signature of the Hague Convention on 13 December 2002 was only meant to signify the end of negotiations and to propose a final text to the formal signature of Contracting States.

¹⁴⁰ See http://www.hcch.net/index_en.php?act=events.details&year=2006&varevent=117

¹⁴¹ See footnote 138.

¹⁴² See in favour of the Convention : K. KREUZER, « Das Haager Übereinkommen über die auf bestimmte Rechte in Bezug auf Intermediär-verwahrte Wertpapiere anzuwendende Rechtsordnung », in *Le droit international privé : esprit et méthodes, Mélanges Paul Lagarde*, Paris, Dalloz, 2005, p. 523 ; J. ROGERS, « Conflict of Laws for Transactions in Securities Held through Intermediaries », Boston College Law School, Research Paper No 108, 2005; Bernasconi and Sigman, “Myths about the Hague Convention debunked”, IFLR, November 2005, 31; D. DEVOS, « The Hague Convention on the Law applicable to Book-entry Securities-Relevance for the European System of Central Banks », in *Liber Amicorum Paolo Zamboni Garavelli*, European Central Bank Publications, pp. 157 et s; Deguée and Devos, “La loi applicable aux titres intermédiés : l’apport de la Convention de La Haye de décembre 2002”, *Revue de droit commercial belge* 2006, p.5-32 ; Financial Markets Law Committee: “Issue 58-Hague Convention...”, Legal assessment produced in November 2005, available on FMLC website: www.fmlc.org; see against the Hague: Opinion of the European Central Bank dated 17 March 2005 (OEJC., n° C 81 of 2 April 2005, p. 10) ; H. DE VAUPLANE et P. BLOCH, « Loi applicable et critères de localisation des titres multi-intermédiés dans la Convention de La Haye », in *Mélanges AEDBF France IV*, *Revue Banque Édition*, 2004, p. 469, also published in *J.D.I.*, 1/2005, p. 3; W.A.K Rank, *Vaststelling Hague Securities Convention: meer rechtszekerheid in het internationale effectenverkeer?*, *NiPR* 2005, p.249.

¹⁴³ http://ec.europa.eu/internal_market/financial-markets/docs/legal_assessment_en.pdf

Member States to sign the Hague Convention with an adjustment to the Settlement Finality Directive to ensure that the freedom given by the Hague Convention to select the law governing the proprietary aspects of book-entry securities will be restricted, for securities systems, to the choice of one single law applicable to the entirety of the securities accounts part of the relevant system, which seems quite obvious in our view¹⁴⁴. EU Member States will have now to consider the findings of this study and take a position on the signature and the proposed adjustment of the related EU framework.

2. The EU Legal Certainty Group

In April 2004, the EU Commission published a Communication on Clearing and Settlement¹⁴⁵ aiming at giving a follow-up to the Giovannini reports¹⁴⁶ listing a number of barriers (including legal and regulatory barriers) in this domain.

The most significant action the Commission suggested to eventually take was to consider a framework Directive on Clearing and Settlement to ensure freedom of services and full right of access (including by clearing and settlement competitors) to clearing and settlement services providers¹⁴⁷. After a deep analysis of the market and active discussion with market players, the Commission is still finalising an impact study, with possible conclusions on the need for such a Directive.

In parallel, as complementary exercises, the Commission has set up three advisory working groups:

- The Advisory and Monitoring Group (called “CESAME”) reviewing the barriers listed in the Giovannini reports and discussing with the Commission topics of harmonisation and definitions of certain concepts (such as CSD, settlement, clearing, core or added value services, etc)¹⁴⁸;

¹⁴⁴ See our studies mentioned in the previous footnote.

¹⁴⁵ Communication of 28 April 2004 from the Commission to the Council and the European Parliament: Clearing and Settlement in the European Union – The way forward”: COM (2004) 0312.

¹⁴⁶ Alberto Giovannini was complaining recently about the insufficient progress made so far in the follow-up of the recommendations of his group (see F.T., 16 May 2005, p. 17)

¹⁴⁷ Several EU jurisdictions retain “national-oriented protection” rules relating to the physical location of securities activities such as:
 - requirements to open or maintain a local office in order to be entitled to act as withholding agent, act as general clearing member, or to act as a recognised CSD or otherwise provide settlement and custody services to local residents;
 - requirements to locate register (for registered securities) or accounts physically in the country of the issuer;
 - requirements (in law or practice) that restricts local membership in CSD to local intermediaries only;
 This can be imposed through laws or regulations, but also through disproportionately requirements to be fulfilled obliging de facto a non-resident firm to act in the local market through a local intermediary.

¹⁴⁸ Documents and minutes of meetings are available on the following website:
http://www.europa.eu.int/comm/internal_market/financial-markets/clearing/cesame_en

- The Legal Certainty Group (“LCG”; it is composed of experts in each EU country, appointed on a personal basis) aiming at identifying needs for legal harmonisation of substantive securities legislation¹⁴⁹;
- The Fiscal Compliance Experts Working Group (“FISCO”) focusing on the identification of tax barriers such as for example certain national legislations requiring foreign intermediaries carrying out business on a remote basis to still use a domestic intermediary as withholding tax agent¹⁵⁰.

Such advisory WGs produced in the course of 2006 reports identifying barriers, possible ways to harmonise securities and tax regimes in the EU with suggested actions. It is now up to the Commission to decide whether it will translate all or part of such recommendations into a Community instrument (Recommendation, Directive, Regulation). In particular, the Legal Certainty Group has recently released a report (“Advice” dated 28 July-11 August 2006)¹⁵¹ which recommends:

- the adoption of new EU legislation harmonising the legal effects of book entries made on securities accounts, on topics similar to Unidroit works (see below);
- to differ the harmonisation of the moment of transfer of ownership until further progress on other EU initiatives relating to corporate actions (see below), and
- to remove legal and regulatory barriers relating to the issuer’s ability to choose the location of its securities (meaning that in some jurisdictions, there are mandatory constraints imposing on the issuer to deposit/register its securities in that country with the national CSD for instance, with limits on the ability for foreign intermediaries to serve similar functions).

Complementary to this, there is a proposal by the EU Commission dated 5 January 2006 on the exercise of voting rights¹⁵² which presents certain links (see Articles 10 and following on proxy voting and split votes) with the works of the LCG with respect to relations between the intermediaries and their clients and the issuer, particularly in intermediated indirect holding patterns. Article 13 of this new proposal is for example stating that omnibus account should be possible in all Member states without the need to segregate (even temporarily) securities in the name of a particular beneficial owner to exercise voting rights and get access to the general meeting.

This would constitute a major improvement in the EU since a number of countries (Greece, Spain, Portugal for example) do not currently recognise the concept of nominee holdings through an omnibus account (which could lead to prohibit voting through nominee), or otherwise prevent or penalise the holding of securities in fungible form, continuing to treat the intermediary as sole shareholder for the total position

¹⁴⁹ Documents and minutes of meetings are available on the following LCG website:

http://www.europa.eu.int/comm/internal_market/financial-markets/clearing/certainty_en.htm.

¹⁵⁰ See http://www.europa.eu.int/comm/internal_market/financial-markets/clearing/compliance_en.htm

¹⁵¹ http://ec.europa.eu/internal_market/financial-markets/docs/certainty/advice_final_en.pdf

¹⁵² “Proposal on the exercise of voting rights by shareholders of companies having their registered office in a Member State and whose shares are admitted to trading on a regulated market” adopted by the Commission on 5 January 2006, COM (2005) 685

recorded on the omnibus account, etc. Others, such as Sweden or Denmark, require segregation for voting purposes.

3. *Harmonisation of market practices and of related legislation and regulation*

Complementarily to these EU official initiatives, market players and infrastructures are also conducting reviews of securities practices (ESCDA, Euroclear, etc) and suggest some harmonisation proposals¹⁵³.

On the legal side, barriers relating to nominee holdings, requirements for local presence, direct access to CSDs, treatment of market claims and harmonisation of record date (date of entitlement to dividends and right to vote when securities are transferred) are examples of what is currently discussed.

A good illustration of the need for legal harmonisation can also be found in the differences in the moment for the transfer of ownership on securities. In a same country, legal transfer of ownership may be treated as taking place on trade date (this was the case until March 2005 in France for stock exchange transactions) while other types of transactions may entail transfer of ownership only on settlement date in the relevant CSD; the latter being the common rule in most EU countries¹⁵⁴. This variety of regimes has a substantial cost impact for market claims and tax processing, as every difference results in a different procedure. This could also generate legal risks to the extent that insolvency of a counterparty occurring between transfer of ownership on trade date according to home stock exchange (SE) rules and settlement date in a foreign settlement system where the settlement of the same transaction actually takes place, may lead to questions about ownership rights.

4. *The Unidroit draft Convention on Intermediated Securities*

¹⁵³ See for example the 75 pages Euroclear Consultation Paper entitled "Harmonisation Fundamentals" dated 30 June 2004, in particular section 8 (page 60) and appendix 1 on legal and regulatory barriers especially in the UK, France, Netherlands and Belgium.

¹⁵⁴ In France, the transfer of ownership (TO) for stock exchange trades (the situation depends on the type of trades) is organised by law (French Monetary and Financial Code, Article 431-2) by reference to the credit of the buyer's account but "at the date and in the conditions defined by (French) market rules". The Euronext Paris market rules then organised the TO at trade date. Because of the harmonisation discussions, this rule has changed in France with the adoption of a new Decree n°2005-303 dated 31 March 2005, which refers to the settlement date (with the crediting of the buyer's account) as moment for transfer of ownership. This new rule is however still dependent on the revision of the Rules of the French market supervisor ("Autorité des marchés Financiers"-AMF; on this complex regime, see H. de Vauplane, "Transfert de propriété des titres cotés: la réforme achevée ...ou presque!"), Rev. Banque, May 2005, p.87.

In Belgium and in the Netherlands, no specific law has been laid down to organise specifically the transfer of ownership for stock exchange or OTC trades. In these two countries, it is the application of the ordinary rules of commercial legislation which leads to the transfer of ownership at settlement date.

Irish and UK laws all provide for transfer of securities based on transfer of legal title on registration. The regulations covering each regime (England and Wales, Scotland, Northern Ireland - all UK - and Ireland) provide for electronic book entry transfer of title effected pursuant to settlement of a properly authenticated dematerialised instruction attributable to one or more members (in accordance with the rules of the securities settlement system). Registration (with associated transfer of ownership) takes place at the point of settlement for the UK jurisdictions. For Ireland, a statutory equitable interest arises in favour of the transferee at the point of settlement and is extinguished (usually minutes - but no more than two hours - later) by transfer of legal title in his favour on an issuer register.

Unidroit started in 2002/2003 a project aiming at defining an international convention to harmonise the substantive regime applicable to intermediated book-entry securities. On the basis of a draft Convention prepared by an ad-hoc WG, Unidroit conveyed in April 2005 in Rome a diplomatic conference to discuss a first draft¹⁵⁵. After interim meetings on specific topics organised in Bern, Sao Paulo and Paris, the plenary Unidroit conference met in March 2006 and produced a revised draft Convention¹⁵⁶ which will be discussed again on 6-15 November 2006.

As also promoted at EU level by the Commission's Communication of April 2004 and its specific Legal Certainty Project (see above I-2), Unidroit is seeking to further enhance legal certainty in intermediated holdings of securities by addressing at least the following issues:

- Legal protection of account holders enforceable in case of insolvency of the relevant intermediary;
- Determination of the rights of the account holder with respect to the securities credited to its account, in particular vis-à-vis the issuer in terms of economical (cash payments, redemption, etc) and non-economical rights (voting rights, etc), including the recognition of nominee pooled holding of securities;
- Protection against misappropriation;
- Protection against upper-tier attachment proceedings at the level of the intermediaries of the relevant intermediary;
- Protection of good faith purchasers/transferees.

The introduction of a specific regime for Collateral transactions (see Chapter VII of the draft Convention: this part has been designed as a model law to be used especially by emerging markets since OECD countries generally have already a sophisticated collateral regime (see Article 9 of US UCC; EU Collateral Directive, etc).

At EU level, the adoption of Unidroit Convention would require a correction of possible inconsistencies which would be identified between the various EU legal instruments adopted on book-entry securities matters. The EU Commission will however be negotiating on behalf of the Community on points of "acquit communautaire" (matters already covered by EU legislation: in particular the Directives on Settlement Finality and Collateral arrangements).

It is probably fair to note that on a worldwide basis, only a few jurisdictions offer today an adequate legal framework for holding and transferring book-entry securities in a cross-border environment. For example, most jurisdictions may provide investors with a sound ownership regime on domestic securities held directly with the domestic CSD or with domestic intermediaries. But only a few legal regimes have organised specific rules for holding and pledging domestically, under domestic law, securities primarily issued

¹⁵⁵ This draft Convention is available on Unidroit website: <http://www.unidroit.org>

¹⁵⁶ See this latest draft Convention on <http://www.unidroit.org/english/publications/proceedings/2006/study/78/s-78-42-e.pdf>

and deposited abroad through an account of the relevant intermediary with the foreign “issuer CSD” or with a local custodian¹⁵⁷.

The current Unidroit draft Convention also defines the duties of the intermediary maintaining a securities account towards the account holder (entries to the account, reversals, finality, securities shortfalls, loss-sharing, etc) in a way which sometimes could overlap with current regulatory regime in place at international (CPSS-IOSCO recommendations for securities systems; see below) or national level.

The ambition of Unidroit is to finalise the adoption of the Convention by end 2006, which seems quite optimistic for such a harmonisation of substantive rules at international level.

5. Regulatory developments relevant for clearing and settlement activities

In November 2001, the Committee on Payment and Settlement Systems (CPSS) of the central banks of the Group of Ten countries and the Technical Committee of the International Organisation of Securities Commissions (IOSCO) published a set of standards: the Recommendations for Securities Settlement Systems¹⁵⁸. The objective of the 19 CPSS-IOSCO Recommendations is to contribute to the financial stability by strengthening the securities settlement systems (SSS) that are an increasingly important component of the global financial infrastructure. The CPSS-IOSCO also developed an assessment methodology¹⁵⁹ for the Recommendations which aimed at providing a clear and comprehensive methodology for the assessments made on the basis of the Recommendations.

The same organisations have published in November 2004 their “Recommendations (15) for Central Counterparties” (CCP/clearing institutions) following the same design than those applicable to securities systems, with the adaptations required for the activity of a CCP which uses netting by novation to interface traders and manages its credit risk through margin requirements and marking-to-market procedures.

Depending on the localisation, there are two or three types of regulatory standards applicable to a clearing or settlement system:

- The “oversight” standards aiming at regulating securities systems to avoid systemic risk: this is the subject of the above-mentioned CPSS-IOSCO Recommendations adopted at G 10 level in 2001 and 2004; and of the new 19 ESCB-CESR Standards adopted at EU level in October 2004 (based on CPSS-IOSCO recommendations with EU adaptations), which are currently on hold because e.g. of divergences of views between regulators concerning the so-

¹⁵⁷ This generally supposes that the interest in such foreign securities is treated as a specific entitlement governed by the national law of the relevant intermediary (under the Hague Convention rules) distinct from any direct traceable entitlement to the underlying foreign securities which remains governed by local ownership law.

¹⁵⁸ "Recommendations for Securities Settlement Systems", CPSS-IOSCO, November 2001 (available on the web site of the Bank for International Settlements: www.bis.org in the CPSS publication section)

¹⁵⁹ "Assessment Methodology for the Recommendations for SSSs"; CPSS-IOSCO, November 2002 (available on the web site of the Bank for International Settlements: www.bis.org in the CPSS publication section)

called “functional approach” (application of standards to major custodians performing activities similar to those of an SSS, etc);

- In the Euro zone, the nine ECB/EMI “Users” standards adopted in 1998 for the use of securities systems in ESCB monetary policy operations. They should be reviewed soon;
- National regulatory standards, where applicable.

Such standards aim at establishing best practices and minimal features for clearing and settlement operators with respect to legal soundness, clearing or settlement efficiency and transparency, risks management (including credit risks where relevant), cash operations, finality, operational reliability, corporate governance, participation/access, links with other systems, etc.

The oversight standards are not law and are generally not directly binding on securities systems. They are adopted by the community of regulators (central banks as overseers¹⁶⁰ and securities/CSDs supervisors) at G 10 and/or at EU level as the basic common rules to carry out their supervisory functions, without prejudice to any additional national regulatory standards which may exist.

The sanctions attached to the non-compliance with such standards (or with the resulting recommendations made by competent regulators to achieve compliance) are generally of an indirect nature:

- Reputation risk: Regulators may make public¹⁶¹ the non-compliance which will obviously affect negatively the image of the system vis-à-vis the outside world: clients, foreign regulators, etc.;
- Foreign regulators may also invoke the system’s non-compliance with international standards to infer negative consequences for the approval of certain projects for which compliance with international standards is required by them;
- Last, under domestic legislation, specific sanctions (fines, criminal sanctions) may be foreseen if a system would not comply with the applicable standards.

There is a risk that such co-existence or superposition of different sets of regulatory rules with sanctions could be perceived by the market infrastructures and their clients as a source of confusion and uncertainty in the regulatory treatment of their activities. This possible perception will not necessarily improve if the current text of the Unidroit Convention (which also contains provisions of a regulatory nature) would be adopted as it stands. If proposed, the EU Directive on Clearing and Settlement should probably also contain provisions which will translate all or part of the ESCB-CESR standards adopted in 2004 and which are currently on hold.

¹⁶⁰ See the CPSS (BIS) report of May 2005 on “Central bank oversight of payment and settlement systems”.

¹⁶¹ The main conclusions of the assessment of clearing and settlement systems against CPSS-IOSCO recommendations are normally published even though there are not so many assessments currently available. National Bank of Belgium has published its main findings in relation to the Euroclear System in its Financial Stability Review in 2005 (p. 105-113).

There is for sure more to come soon.

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Diego Devos