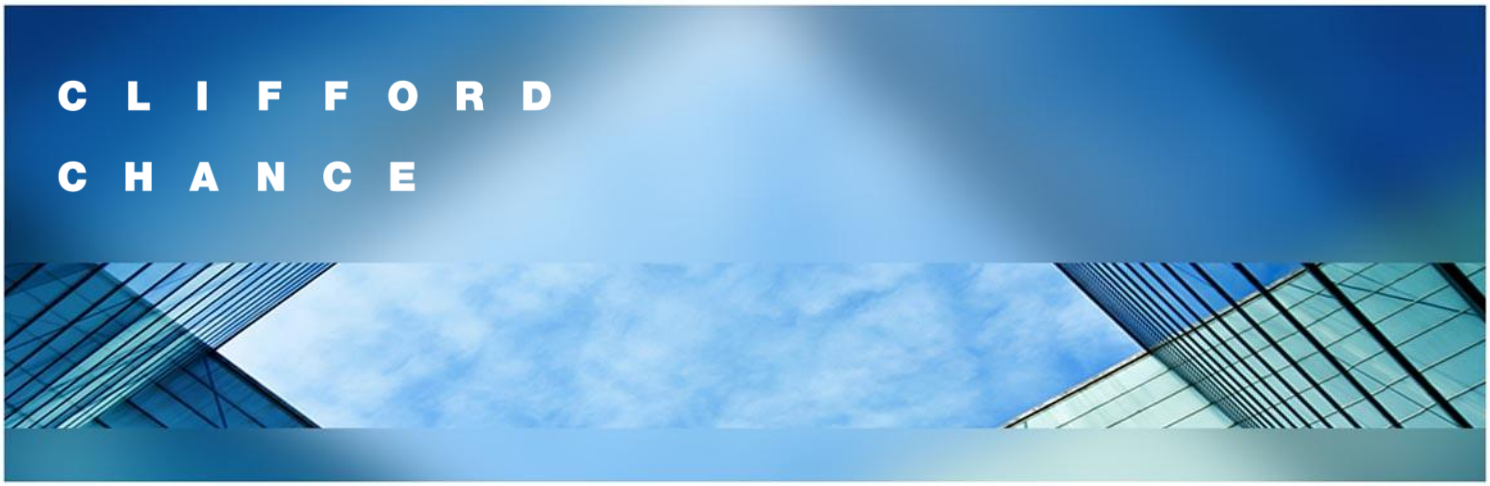

EUROPEAN COMMISSION LAUNCHES SFD AND FCD CONSULTATIONS

The European Commission has recently launched two targeted consultations on the Settlement Finality Directive (98/26/EC) (SFD) and the Financial Collateral Directive (2002/47/EC) (FCD). The consultations consider issues arising from market developments and regulatory changes and aim to ensure coherence across the different legislative frameworks in which the two directives have been operating. The "trigger" for the consultations was Article 12a of the SFD, requiring the European Commission to produce a report on the SFD by 28 June 2021 but, due to the close links between the two directives, the European Commission has decided to review both in parallel.

REVIEWING THE FINANCIAL COLLATERAL DIRECTIVE

The FCD facilitates the cross-border use of financial collateral primarily by removing national law formalities and offering harmonised protections against insolvency challenges in certain cases. In addition, the FCD ensures that certain close out netting provisions are enforceable in accordance with their terms.

However, the level of harmonisation is not complete as the FCD has been implemented differently across the EU. The UK implementation of the FCD continues to apply following Brexit but may diverge over time, in particular if the consultation leads to changes in the EU that are not adopted in the UK.

The consultation considers the categories of entity that can enter into a financial collateral arrangement, the types of collateral that can be provided under a financial collateral arrangement and how parties should establish "possession" or "control" over collateral, which is a cornerstone of a financial collateral arrangement.

Entity scope

The scope of the FCD is not unlimited. One restriction is that the protections only apply when the entities acting as collateral taker and collateral provider are types of entity that are within the scope of the applicable implementation of the FCD. Different member states have implemented this scope in a variety of ways and there is therefore an inconsistent approach as to which entities can benefit from the protections afforded under the FCD. The Commission's review therefore considers

Key issues

The SFD and FCD consultations consider issues arising from market developments and regulatory change, as well as national transposition inconsistencies and interaction with other legislation.

The FCD consultation focuses on:

- revising the types of entity and collateral types that are in scope
- clarifying the requirements of "possession" and "control" and the concept of "awareness of pre-insolvency proceedings"
- achieving further harmonisation around the requirement that close out netting arrangements should take effect in accordance with their terms notwithstanding the onset of insolvency proceedings of a counterparty

The SFD consultation focuses on:

- extending the scope of the SFD to cover EU institutions participating in third country systems, as well as new entity types
- enabling the SFD to apply in a permission-less DLT context
- amending the protections relating to collateral security so that these can apply in the context of client clearing
- clarifying and/or revising the concepts of irrevocability and the point in time at which an order enters the system

whether the current list of "in scope" entities should be extended or amended. In this respect, the consultation seeks views on:

- whether new financial entity types that have emerged in recent years should also come within scope – such as e-money institutions, payment institutions and central securities depositories;
- whether the current FCD requirement that at least one of the parties to a financial collateral arrangement (FCA) has to be a financial institution, public authority or central bank should be retained (and if not, how this should be amended - for example, should it be removed altogether, or should the list of entities be extended further); and
- whether the article 1(3) opt out provision, enabling member states to exclude FCAs from the scope of the FCD where they are entered into by retail / small and medium sized companies, should be retained and/or made obligatory, thereby effectively rendering the FCD exclusively applicable to wholesale markets.

Types of "in scope" financial collateral

The FCD currently covers collateral over cash, financial instruments and credit claims. There have been suggestions that the FCD should be amended so that where a credit claim is provided as financial collateral then any set off rights enjoyed by the original debtor (or third party that the credit claim is subsequently assigned to) should be excluded. Such set-off rights may make valuation of the credit claim difficult and potentially complicate the analysis regarding the possession or control of the credit claims. The potential policy benefits of this exclusion are thrown into sharp relief because central banks often accept credit claims as collateral but the consultation acknowledges that any such exclusion will inevitably disadvantage the debtor and give rise to issues in the context of debtor protection and consumer protection.

Moreover, in light of recent market and technological developments, the consultation asks respondents whether the scope of the FCD should be extended to encompass additional collateral types, such as stablecoins (once these become regulated), including e-money tokens and asset referenced tokens, emission allowances and certain derivatives. Extending the scope of financial collateral to stablecoins would need to address how the possession and control requirements would operate in a distributed ledger technology (DLT) setting, where novel questions relating to legal ownership are likely to arise. It is also unclear how the collateral taker would enforce its rights where the collateral taker relies on third party actions (for example, where keys owned by different parties are needed for a transfer to be effected). The consultation asks whether the FCD will need to be more prescriptive in respect of ownership, possession and control requirements in different contexts, whether FCD terminology will require adjustment (especially the notions of "account" and "book entry") and how this could be done in a manner compatible with national laws on property rights etc.

"Provision" of different collateral types

The meaning of "possession" and "control" (as these terms are used in the FCD) has been debated for many years. The uncertainty is especially acute in respect of claims or rights in, or relating to, financial instruments (such as dividends or interest), as well as in respect of intangible collateral (the consultation specifically mentions, as an example, money deposited in a bank account)[1]. The consultation therefore asks whether the FCD should be more prescriptive as to how certain types of collateral should be evidenced and whether the terms "possession" and "control" should be clarified (potentially for each type of collateral). Although the nature of a title transfer financial collateral arrangement means that, on its face, it is likely to be easier for the collateral taker to establish the relevant "possession" or "control" of the collateral, the consultation raises the issue of the lack of harmonisation around the rules on good faith acquisition across the different member states and notes that this may lead to further inconsistency.

Awareness of pre-insolvency proceedings

Article 8(2) of the FCD requires a collateral provider to prove that it was not aware nor should have been aware of the commencement of insolvency or reorganisation proceedings in order for the relevant financial collateral safeguards to apply. The consultation asks whether clarification is needed as to how such awareness is to be determined and what a collateral taker needs to establish in order to "prove" that it was not aware nor should have been aware of the commencement of relevant proceedings. For example, would it be sufficient that the collateral taker was unaware of the opening of the insolvency proceedings at the time the collateral agreement was concluded or must it be unaware of the opening of the

[1] See also case C-156/15 of November 2016 – Private Equity Insurance Group SIA v Swedbank, which reiterated that the circumstances in which these criteria are fulfilled are not specified in the FCD.

proceedings at the moment of the delivery, transfer or registration of the financial collateral so as to be in its "possession" or under its "control"?

Close out netting arrangements

The FCD provides that certain close out netting arrangements should take effect in accordance with their terms notwithstanding the onset of insolvency proceedings of a counterparty. In its 2017 report[2] the European Post Trade Forum flagged that this protection is not adequate in a cross-border setting as it requires due diligence to ascertain whether the close out netting provision is enforceable on a counterparty insolvency. In the Forum's view, the issue is further complicated by member state transposition of the Bank Recovery and Resolution Directive (Directive (EU) 2014/59) and the Framework for the Recovery and Resolution of Central Counterparties (Regulation (EU) 2021/23), which disapply through their amendments to article 1(6) of the FCD the protections for close out netting arrangements in respect of restrictions imposed by virtue of a resolution action of a resolution authority, subject to safeguards. Accordingly, the consultation asks whether respondents have encountered problems with the recognition or application of close-out netting provisions, what impact (if any) the above-mentioned directives have had on legal opinions, whether the introduction of article 1(6) of the FCD has resulted in legal uncertainties and whether further harmonisation in this area would be helpful.

REVIEWING THE SETTLEMENT FINALITY DIRECTIVE

The SFD protects systems that fall in scope of its provisions as well as domestic and foreign participants thereof by ensuring the irrevocability and finality of transfer orders entered into the system against insolvency proceedings. In addition, it provides for the enforceability of the netting of transfer orders and ringfences collateral security provided in connection with participation in a system or in the monetary operations of member states' central banks / the European Central Bank in an insolvency situation.

Third-country systems

Currently the SFD does not extend its protections to systems governed by the laws of a third country. Recital 7 gives the option to member states to apply the SFD's protections to domestic institutions participating directly in third country systems and to any relevant collateral security. The consultation asks respondents to consider whether the scope of the SFD should be extended to cover EU institutions participating in third country systems, and if so what the best way of achieving this would be. The consultation identifies a number of questions for consideration:

- Should the provisions of the SFD apply directly to the third country system or should the SFD defer to national law protections applicable in the third country in question?
- Should a compatibility assessment be carried out between the two legal systems and should there be a requirement for some form of reciprocity, or at least common standards, and information sharing provisions (especially as to insolvency of participants)?
- Should the SFD set out certain requirements that would have to be met or should an assessment be carried out on a case by case basis? And once designated, should there be a process of regular evaluation of the system?
- What are the relevant conflicts of law provisions that apply? This is an important question because it will determine interpretation issues such as when transfer orders become irrevocable and what qualifies as a system.

Eligible participants

In line with the FCD consultation, the SFD consultation also examines whether new financial entities that have emerged in recent years should come within its scope as direct participants (such as e-money institutions, payment institutions and central securities depositories). There is also discussion as to whether participants should be vetted on the basis of specific risk assessments and/or on grounds of systemic risk, as well as to whether non-designated system operators should also be able to qualify as eligible participants.

Technological innovation and the SFD

Although the SFD has been drafted so as to be technologically neutral, stakeholders have argued that some of its requirements restrict the use of DLT and cryptoassets. The consultation therefore considers whether certain concepts of the

[2] https://ec.europa.eu/info/sites/info/files/170515-eptf-report_en.pdf.

SFD work in a permission-less DLT context, where there is no centralised operator and the participants are not identified. The consultation considers whether it is necessary to adjust concepts such as "system", "transfer order", "book entry" and "settlement account and agent" for these purposes. The consultation highlights the risk of legal responsibilities being unclear and the need to consider whether conflicts of laws and links with other financial markets infrastructures will need revisiting.

Provision of collateral by clients of participants

Even though the definition of "collateral security" that is protected for the purposes of the SFD is wide and covers "all realisable assets" given in connection with participation in a system that is in scope or in connection with the monetary operations involving member states' central banks or the European Central Bank, the SFD requires that the collateral giver be one of the following: (a) a participant in a system or in an interoperable system, (b) a system operator of an interoperable system that is not a participant, (c) a counterparty to the central bank of a member state or the European Central Bank or (d) a third party that provided the collateral security in question. Accordingly, collateral security provided by a client of a participant in a system may not be protected under the SFD in the event that the participant or the system operator go into insolvency proceedings. The consultation considers whether the SFD provisions should be extended in this respect, for example to protect collateral security in the context of client clearing at CCPs where a clearing member participant or a CCP that is a system operator for the purposes of the SFD become insolvent. In this context, the consultation asks respondents to consider what requirements (if any) should be imposed on a client in order to qualify for this protection (for example, if its identity should be known to the system operator, if a risk assessment ought to be done on the client or if it should have its own segregated account).

Questions on settlement finality

Two key concepts underpinning the SFD are the point in time at which an order enters the system and irrevocability. This is important because if a participant goes into insolvency proceedings, different timestamps in interoperable systems could prove problematic. The consultation questions whether these concepts work as currently drafted and whether changes are required. Specifically, respondents are asked for their views on:

- whether the SFD should more clearly stipulate the legal duty for a system to specify the moment of entry into the system and of irrevocability as well as where settlement is irrevocable and enforceable, as current divergences of definition on these points undermine legal certainty;
- whether the SFD should be amended to accommodate the specificities of clearing systems both under business as usual and market stress conditions (for example as part of default management procedures); and
- whether a provision should be added in the SFD to ensure that the moment of settlement finality is identical in relation to the cash and the security leg of a transaction that is settled based on DvP (delivery versus payment), as currently the two legs are treated separately.

Interaction with other legislation and national transposition issues

Both consultations ask respondents to consider the interaction of the SFD and FCD with other legislation; the EU Insolvency Regulation (Regulation (EU) 2015/848), the Second Chance Directive (Directive (EU) 2019/1023), the Bank Recovery and Resolution Directives (Directives (EU) 2014/59 and 2019/879), the Framework for the Recovery and Resolution of Central Counterparties (Regulation (EU) 2021/23) and (in the case of the SFD only) the Second Payment Services Directive (Directive (EU) 2015/2366) are mentioned in this respect.

The consultations also ask respondents to flag any issues that they have encountered as a result of inconsistencies in national transposition.

WHAT'S NEXT?

The deadline to respond to both consultations is 7 May 2021. The Commission will then prepare its final report and any legislative proposals for amendments to the FCD and SFD.

CLIFFORD
CHANCE

CONTACTS

Chris Bates
Partner
T +44 20 7006 1041
E chris.bates
@cliffordchance.com

Michael Brown
Senior Associate
T +44 20 7006 8359
E michael.brown
@cliffordchance.com

Caroline Dawson
Partner
T +44 20 7006 4355
E caroline.dawson
@cliffordchance.com

Laura Douglas
Senior Associate
T +44 20 7006 1113
E laura.douglas
@cliffordchance.com

Caroline Meinertz
Partner
T +44 20 7006 4253
E caroline.meinertz
@cliffordchance.com

Maria Troullinou
Senior Associate
T +44 20 7006 2373
E maria.troullinou
@cliffordchance.com

Jeremy Walter
Partner
T +44 20 7006 8892
E jeremy.walter
@cliffordchance.com

Lounia Czupper
Partner
T + 32 2 533 5987
E lounia.czupper
@cliffordchance.com

Bert De Maeyer
Managing Partner
T + 32 2 533 5055
E bertde.maeyer
@cliffordchance.com

Frédérick Lacroix
Partner
T + 33 1 4405 5241
E frédérick,lacroix
@cliffordchance.com

Marc Benzler
Partner
T + 49 69 7199 3304
E marc,benzler
@cliffordchance.com

Lucio Bonavitacola
Partner
T + 39 02 8063 4238
E lucio.bonavitacola
@cliffordchance.com

José Manuel Cuenca
Partner
T + 34 91 590 7535
E josemanuel.cuenca
@cliffordchance.com

Marc Mehlen
Partner
T + 352 48 50 50 305
E marc.mehlen
@cliffordchance.com

Andrzej Stosio
Partner/Advocate
T +48 22429 9469
E andrzej.stosio
@cliffordchance.com