**ISLA response to the targeted consultation on the review of the Financial Collateral Directive:**

The International Securities Lending Association (**ISLA**) and its members welcome the opportunity to respond to the European Commission's targeted consultations on the review of the Financial Collateral Directive (**FCD**).

1. **FINANCIAL COLLATERAL DIRECTIVE** 
   1. **Scope**

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| **1.1 Should the personal scope of the FCD be amended to include the following entities:**  **(a) Payment institutions;**  **(b) e-money institutions;**  **(c) central securities depositories;**  **(d) any other entities?** |

In line with the Commission's statement, the personal scope of the FCD should be extended to cover systemically important collateral takers and providers. As central securities depositories are a key part of EU financial market infrastructure it is logical to extend the personal scope of the FCD to include them (to the extent that there are not separately already within scope).

In addition, we note that the market continues to evolve and, on that basis, suggest that payment institutions and e-money institutions could be usefully added to ensure that the market retains the protections set out within the FCD.

The FCD provides an important function in recognising the efficacy of netting mechanisms and giving effect to security arrangements. These arrangements permit the efficient mitigation of credit risk and promote efficient markets. These mechanisms also underpin the analysis for the regulatory capital treatment, where applicable, and correspondingly it is desirable for there to be as much certainty as possible in respect of such arrangements.

On that basis, we consider it advantageous for the personal scope of the FCD to be as broad as possible.

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| **1.2 Do you agree with maintaining the current rationale that only financial collateral arrangements should be protected where at least one of the parties is a public authority, central bank or financial institution?**  **1.2.1 Please explain why and how the rationale should be changed in your opinion?** |

No.

As noted above, the protections provided by the FCD support the credit mitigation techniques that support efficient markets and we therefore consider it advantageous for those protections be as broad as possible.

On that basis, we consider it advantageous for the personal scope of the FCD to be as broad as possible.

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| **1.3 Does the exclusion in Article 1(3) (allowing Member States to exclude retail / SME from the scope of the FCD) present any problems to the cross-border provision of collateral in your opinion?**  **1.3.1 If yes, please explain why the exclusion in Article 1(3) presents any problems to the cross-border provision of collateral in your opinion.** |

Yes.

The partial implementation of the SME opt-out in a handful of Member States limits the scope of financial products and service providers available to certain unregulated corporates. We believe that financial institutions should benefit from the protections of the FCD when facing unregulated corporates in all Member States. This would mitigate the risks to financial institutions of conducting such activity and improve the cross-border provision of collateral in Europe.

Any variance in the application of the protection provided under the FCD requires participants to individually assess the risks for each relevant counterparty in each applicable jurisdiction and this could be mitigated if the protections provided by the FCD were as broad as possible. The present system requires complex legal analysis for cross border transactions and this promotes a lower level of legal certainty regarding the application of the credit mitigation techniques that the FCD seeks to protect.

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| **1.4 Should the FCD be exclusively applicable to the wholesale market (i.e., turning the national opt-out for retail / SME granted under Article 1(3) into a binding FCD provision)?**  **1.4.1 Please provide an explanation / further information if you would like to.** |

No.

As noted above, the protections provided by the FCD support the credit mitigation techniques that support efficient markets and we therefore consider it advantageous for those protections be as broad as possible. We note that most Member States did not implement the corporate opt-out in full and we consider that making the SME opt-out into a binding provision would adversely affect the cross-border provision of collateral in Europe.

* 1. **Provision of cash and financial instruments under the FCD**

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| **2.1 Do you see the need to specify the ways in which financial collateral such as dividend or interest ("claims relating to or rights in or in respect of") could be evidenced in writing when it is provided separately from its financial instrument?**  **2.1.1 Please explain how this could be done.** |

No.

We consider that there is sufficient clarity on this point, and that amending the FCD to specify this further would risk unintended consequences (e.g., excluding some types of financial collateral that are currently eligible). Notwithstanding the above, we suggest ensuring that any evolution in the market is not undermined by uncertainty as to whether the protections afforded by the FCD would apply.

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| **2.2 Do you think that the concepts of "possession" and "control" in the FCD require further clarification?**  **2.2.1 Please explain why you think that the concepts of "possession" and "control" in the FCD require further clarification and for which type of collateral. Please elaborate how this should be done in your opinion.** |

Yes.

National implementing legislation has provided guidance on the concepts of "possession" and "control" under the FCD. This has not been sufficient to preclude litigation in respect of the meaning of the terms (including in the UK, while the UK was still a part of the EU). Although it remains appropriate for detailed guidance to be provided at a national level, as each jurisdiction has its own laws on security and insolvency procedures, we consider that further high-level guidance could be usefully provided at the EU level. It is essential that such guidance should provide market participants with additional flexibility and not introduce any prescriptive formalities or requirements. We agree with the specific proposals made in the consultation response provided by ISDA.

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| **2.3 Do you believe that the notion of a good faith acquirer within the EU should be further clarified in the FCD?**  **2.3.1 Please explain how this might be done for "cash" and "financial instruments".** |

No.

We consider that the notion of a good faith acquirer is a concept that is best addressed on a per jurisdiction basis rather than in the FCD.

* 1. **"Awareness" of (pre)insolvency proceedings**

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| **3.1 Do you see the need to clarify how "awareness" of (pre-)insolvency proceedings under Article 8(2) of the FCD is determined?**  **Please explain in your opinion clarifying how a collateral taker can "prove that he was not aware" could be done.**  **Please explain in your opinion clarifying how a collateral taker can "prove that he should not have been aware" could be done.** |

Yes.

We consider that it could be helpful to clarify this requirement further. We would welcome providing guidance on the nature of this requirement and reversing the standard of proof (so that it must be demonstrated that the collateral receiver was aware in order for the protection to not apply, rather than requiring the collateral receiver to demonstrate that they were not aware). We consider this preferable as it creates a greater level of certainty and, in any event, proving a negative can be difficult to achieve in even the most favourable fact patterns.

* 1. **Recognition "close-out netting provisions" in the FCD and its impact on SFD systems**

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| **4.1 Have you encountered problems with the recognition / application of close-out netting provisions?**  **4.1.1 What were these problems related to? [use within one Member State? Cross-border use? Both?]**  **4.1.2 What did these problems concern? [OTC transactions / transactions carried out on an SFD system / both]**  **4.1.3 Please describe the problems and the outcome.**  **4.1.4 Please describe a solution that you consider appropriate.** |

As noted above, the protections provided by the FCD provide significant comfort in respect of credit risk mitigation techniques used in the market and, where relevant, support the analysis in respect of regulatory capital requirements. We consider it advantageous for the FCD to have as broad an application as possible and for national divergence to be minimised. When there are discrepancies in the requirements for the FCD's protections to be provided (for example, arising from variations in personal scope, acceptable financial collateral or governing law requirements) this impedes the certainty in the market and can lead to fewer market participants being willing to transact with particular counterparties or in certain fact patterns (as well as creating additional expense in determining the level of comfort regarding the application of the protections of the FCD).

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| **4.2 In case you have collected legal opinions regarding the enforceability of close-out netting: are they upheld or to be changed in light of the framework for the recovery and resolution of central counterparties (Regulation (EU) 2021/23)?**  **4.2.1 Please specify why and how the legal opinions you have collected were changed.**  **4.3 In case you have collected legal opinions regarding the enforceability of close-out netting: were they upheld or changed in light of the revision of the BRRD (Directive 2014/59/EU)?**  **4.3.1 Please specify why and how the legal opinions you collected were changed.** |

ISLA commissions a wide range of legal opinions to support the securities lending agreements published by ISLA. These opinions focus on the set-off/netting analysis in a range of jurisdictions and also consider whether certain security arrangements qualify as security financial collateral arrangements. These opinions relate to uncleared transactions and therefore the framework for the recovery and resolution of central counterparties will only be relevant to the extent the opinions consider the analysis when facing central counterparties acting in private capacity.

These legal opinions will consider in detail the effect of BRRD2, as implemented into applicable national law, and will include all appropriate qualifications arising from the regime. These will typically include any stay or moratorium on termination and/or enforcement of security and firms will consider the implications of these qualifications when considering any contractual arrangement with a potential counterparty.

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| **4.4.1 Do you see legal uncertainties related to close-out netting provisions due to the FCD's silence regarding the application of national avoidance actions to such provisions?**  **4.4.1.1 Please explain the legal uncertainties you have identified and how these might be solved.** |

Yes.

There are currently no applicable provisions on the EU level which aim to harmonise the avoidance provisions in the context of insolvency or similar proceedings in the national laws of the Member States. We would welcome close-out netting, to the extent it relates to financial obligations, being exempted from national avoidance provisions.

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| **4.4.2 Do you see legal uncertainties related to close-out netting provisions by virtue of the introduction of Article 1(6) of the FCD?**  **4.4.2.1 Please explain the legal uncertainties you have identified and how these might be solved.** |

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| **4.5 Do you consider that there is a need for further harmonisation of the treatment of contractual netting in general and close-out netting in particular?**  **4.5.1 Please explain your reasons as well as possible solutions taking into account possible interactions with other national or EU law and the importance of close-out netting for risk management and the calculation of own funds requirements for credit institutions and investment firms under the CRR.** |

Yes.

We consider that it would be helpful for EU legislation to provide for further harmonisation of the treatment of contractual netting in general, and close-out netting in particular, irrespective of whether such arrangement forms part of a financial collateral arrangement.

This is a broader issue and will affect other sections of the market more significantly than securities lending agreements in particular, since the standard documentation includes a collateral component so the FCD protections should apply (subject to the discussions above on the expansion in scope of the FCD) unless parties have modified the documentation to enter into uncollateralised transactions.

It is not uncommon, however, for parties to agree to enter into uncollateralised transactions and create a netting set that consists of a mix of collateralised and uncollateralised transactions or consists solely of uncollateralised transactions giving rise to exposures to each party. The benefits of close-out netting for either type of netting set are recognised in the regulatory framework of the financial market in the EU (e.g. in the CRR and BRRD) but, without additional protections in the local implementation or under other local law, the FCD currently only clearly safeguards close-out netting in connection with a financial collateral arrangement. The FCD does not, without additional protections in the local implementation or under other local law, create a general legal framework for close-out netting regarding netting sets of uncollateralised financial obligations and on that basis we consider that the FCD could be helpfully expanded to address this. If considered preferable, this issue could instead be dealt with in legislation addressing the efficacy of close-out netting arrangements more broadly.

* 1. **Financial collateral**

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| **5.1 Do you think other collateral than cash, financial instruments and credit claims should be made eligible under the FCD?**  **5.1.1 If so, please elaborate which type of collateral and why.** |

No, subject to our comments below regarding crypto-assets that should qualify as financial instruments.

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| **5.2 Do you see the need to update the definitions of currently eligible collateral? [cash / financial instruments / credit claims]**  **Please explain why and how updating the definition of cash should be done.**  **Please explain why and how updating the definition of financial instruments should be done.**  **Please explain why and how updating the definition of credit claims should be done.** |

We consider that updates could be helpfully made to the definitions of cash and financial instruments and agree with the specific proposals made in the consultation response provided by ISDA.

We do not see a need to update the definition of credit claims, although note it is less relevant to securities lending arrangements.

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| **5.3 Should emission allowances be added to the definition of financial instruments in the FCD?** |

Yes, they are a commonly used financial collateral and should therefore be eligible as collateral under the FCD.

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| **5.4 For crypto-assets qualifying as financial instrument, would you see a need to specify the ownership, provision, possession and control requirements of the FCD further for a DLT context in order to provide legal certainty as to the question whether they are covered within the FCD?**  **5.4.1 Please elaborate on how this might be done in a manner that is compatible with national laws regarding securities, companies, contracts, property and book-entry.** |

No.

Where crypto-assets qualify as a financial instrument, we consider that the provisions of the FCD that relate to ownership, provision, possession and control of other financial instruments should be sufficient to address these issues as they apply to crypto-assets. It should not be necessary to specify these issues further in the context of distributed ledger transactions. DLT is ultimately a mechanism for transferring (and recording the transfer of) assets – it does not confer additional or different rights regarding ownership, possession or control that would need to be reflected in the FCD.

Please note, however, our response to 7.3.

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| **5.5.1 Should the notions of "account" be retained, replaced or further clarified / specified for the purposes of evidencing the provision of cash or securities collateral provided through DLT?**  **Please explain why you think so and how this matter might be solved.** |

Retained.

The FCD defines "relevant account" in relation to book entry securities collateral which is subject to a financial collateral arrangement, 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.

This definition is sufficiently broad to cover a register or account that may be maintained using DLT. In this context, however, please note our response to 7.3.

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| **5.5.2 Should the notions of "book-entry" be retained, replaced or further clarified / specified for the purposes of evidencing the provision of cash or securities collateral provided through DLT?**  **Please explain why you think so and how this matter might be solved.** |

Retained.

The FCD defines "book entry securities collateral" as financial collateral provided under a financial collateral arrangement which consists of financial instruments, title to which is evidenced by entries in a register or account maintained by or on behalf of an intermediary.

This definition is sufficiently broad to cover a register or account that may be maintained using DLT.

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| **5.6 Are there any other issues you would like to address regarding FCD financial collateral in a DLT environment?**  **5.6.1 Please elaborate on how this might be done in a manner that is compatible with national laws regarding securities, companies, contracts, property and book-entry.** |

No.

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| **5.7 In your opinion, do existing provisions on set-off create a problem for the provision of credit claims as collateral?**  **5.7.1 What is the context of this problem? [national context, cross-border context, both of the above]** |

Not relevant

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| **5.7.2 Do you see the need to remove a debtor's set-off rights? Please consider the set-off risks against the risks to households and SMEs in the event of the insolvency of a credit institution?**  **5.7.2.1 Why do you see the need to remove a debtor's set-off rights?**  **5.7.2.2 Under which conditions should such a removal take place?** |

No, it is for the collateral taker to decide what kind of collateral they accept and ensure appropriate risk mitigation where applicable.

* 1. **The FCD and other Regulations / Directives**

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| **6.1 Is there any legislation where provisions are not sufficiently clear in terms of their interaction with the FCD or the other way around?**  **6.1.1 Insolvency Regulation (Regulation (EU) 2015/848) – please explain why you think the provisions of the Insolvency Regulation are not sufficiently clear in terms of their interaction with the FCD or the other way around. Please also explain how this matter might be solved.**  **6.1.2 Second Chance Directive (Directive (EU) 2019/1023)**  **6.1.3 BRRD (Directive (EU) 2014/59/EU)**  **6.1.4 Framework for the recovery and resolution of central counterparties (Regulation (EU) 2021/23)**  **6.1.5 If there is any other legislation where provisions are not sufficiently clear in terms of their interaction with the FCD or the other way around, please specify which ones, explain why, and explain how this matter might be solved.** |

N/A

* 1. **Other issues**

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| **7.1 To what extent have inconsistencies in the transposition of the FCD caused cross-border issues which would merit further harmonisation? Please provide examples of such instances.**  **7.2 How could we further enhance cross-border flows of financial collateral across the EU?** |

N/A

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| **7.3 Is there anything else you would like to mention?** |

Prior to proposing any amendments to the FCD (or any similar or related legislation) to facilitate or promote the use of either DLT or crypto assets within the EU, we would encourage the Commission to conduct a thorough review and impact assessment on the potential impact of any such modifications on financial transactions not making use of DLT or crypto assets.

In particular, we are conscious that there is a broad spectrum of DLT platforms and that crypto asset can fall into a number of different categories. As discussed in our above comments, some of these may qualify as financial instruments (and may be capable of being treated in the same way as any other financial instrument under MiFID), and others may not. The proposed Markets in Crypto Assets Regulation will introduce new requirements in relation to the latter category, and it may be worth reviewing the treatment of these assets again once that Regulation has come into effect.

Creating a precise definition or taxonomy of different types of DLT system and/or crypto asset or digital asset is challenging, due in part to the rapid development of the technology, the range of platforms used and the kind of assets that are digitally represented on these platforms. There is currently no such taxonomy at an EU or international level. This lack of taxonomy presents difficulties in determining the extent to which DLT-based collateral systems might fall within or outside of the scope of the FCD. For example:

* Does the DLT system's operational set-up provide for the creation of an "account" or "relevant account"?
* Do crypto assets constitute "cash" or "financial instruments"?
* How is collateral in the form of crypto assets provided and how does the collateral taker demonstrate that it has sufficient "control" of the collateral?

Where assets do not fall within the existing framework (e.g., because they do not qualify as financial instruments under MiFID, or because the relevant system does not involve registers or accounts that fall within the definitions of "account" or "relevant account" under the FCD), the answer is not automatically to be to amend or broaden the scope of the FCD to include these assets and systems. As noted above, this may give rise to unintended consequences, and it may be wholly inappropriate to include them within the scope of the FCD. Rather, we consider that the Commission should undertake a detailed review of these assets and systems to understand the issues associated with trading these assets or trading through these systems and assess whether they should be included within the scope of the FCD, whether it may be appropriate to legislate separately to manage any identified risks or whether further legislation is not necessary at this stage.

We would be happy to discuss these and other relevant issues further with the Commission.