7 May 2021

Unit C2 - Financial markets infrastructure
Directorate-General for Financial Stability, Financial Services and Capital Markets Union
European Commission
1049 Bruxelles
Belgium

Dear Sir or Madam

Targeted Consultation on the Review of the Directive on Settlement Finality in Payment and Securities Settlement Systems

The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

In February 2021, the European Commission published a consultation to gather views on the functioning of Directive 98/26/EC on settlement finality in payment and securities settlement systems (the "**Settlement Finality Directive**" or the "**SFD**"). The SFD protects a duly designated, notified and published system ("**SFD system**") and its participants from the legal uncertainty and unpredictability inherent in the opening of insolvency proceedings against one participant. The FMLC would like to draw attention to legal uncertainties which arise owing to developments in the business, technological and regulatory environment since the last review of the SFD in 2008/2009.

Protection of systems

Recital 7 of the SFD allows Member States to apply the provisions of the Directive to their domestic institutions which participate directly in Third Country systems and to collateral security provided in connection with participation in such systems. The European Parliament had previously sought to extend the protections of the SFD to any non-E.U. (Third Country) system where at least one (direct) participant had its head office in the E.U. but this proposal was not adopted. Instead, a new Article 12a was added to the SFD requiring the European Commission to report on how Member States apply the SFD to domestic institutions which participate directly in systems governed by the law of a Third Country and to collateral security provided in connection with their participation. In the context of the withdrawal of the U.K. from the European Union, several Member States have introduced new regimes under their national law pursuant to Recital 7 in order to provide a framework for entities accessing Third Country—including U.K.—systems. Question 1.1 asks whether E.U. institutions that participate in Third Country systems should be protected by the SFD as a matter of E.U., not Member State, law.

The FMLC would suggest, however, that it would be more accurate to view an extension of the SFD's protections as an extension to Third Country systems and their operators. Without the extension of SFD protections to Third Country systems, Third Country system operators face uncertainties—in the event of a participant's insolvency proceedings and litigation—relating to whether E.U. laws respect the finality of their records, the irrevocability of transfer orders that enter the Third Country system, the effectiveness of any actions taken by the system operator to limit systemic or other risk in the face of a participant's default or the enforcement of collateral security taken in connection with participation in the system. The Third Country system operator's ability to prevent the default spreading systemically throughout the E.U. and globally may also be impacted.

To that end, the FMLC would support the extension of the SFD's protections to Third Country systems that are designated by the relevant designating body under the SFD. In answer to Question 1.3, which asks how the scope of the SFD should be extended to E.U. institutions participating in Third Country systems, those protections should apply in their entirety. Crucially, this would include Article 8, which provides that, in the event insolvency proceedings are opened against a participant in a system, the rights and obligations arising from, or in connection with, the

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participation of that participant shall be determined by the law governing that system. As a result, upon the opening of insolvency proceedings against an E.U. participant, an E.U. Member State court would be required to defer to the finality afforded under the Third Country system's rules when determining questions relating to the rights and obligations of the E.U. participant arising from, or in connection with, its participation in the Third Country system.[1] Such an extension would enable the safe and efficient operation of the system and provide certainty to the operator of the Third Country system, which would only need to consider a single country's law, in turn helping to reduce any conflict of laws risk. In addition, such an approach would ensure a coherent, consistent and non-discriminatory approach under the SFD between E.U. and Third Country systems. Members of the FMLC have considered the protections afforded by the SFD within the wider considerations for financial stability (for the E.U. and international financial markets) and the control of contagion risk.

With regards to how the SFD should be extended to E.U. institutions participating in Third Country systems, it should be noted that adopting a conflict of laws solution outside the scheme of Article 8—which purports to defer to the protections conferred by the Third Country law, but potentially leaves a residual set of issues for determination by reference to local Member State insolvency law—may in fact give rise to increased legal uncertainty. One option put forward in Question 1.3 of the Consultation is that the SFD should defer to the protections conferred by applicable Third Country law, apparently without providing for carve-outs under E.U. insolvency laws. The efficacy of such conflict of law rules for Third Country systems (which are already in place under national E.U. regimes such as Spain and Belgium) depends on: (i) a Court or official determining that the relevant matter falls within the scope of the conflicts of law carve-out as a matter of characterisation (taking into account, for instance, how similar the Third Country system is to systems or relevant matters protected under national law); and (ii) the presumption that national law is equal to foreign law in Court proceedings and foreign law is capable of rebuttal by expert evidence (which may be a high burden to satisfy). Such an approach would introduce significant legal uncertainties compared to the other options put forward, such as explicit protection from EU insolvency laws for Third Country systems. In a similar vein—and in response to Question 1.4 which asks whether an assessment should be carried out to ascertain if the Third Country's applicable law is comparable to the provisions under the SFD—the FMLC's view is that an assessment focused the comparability of the provisions may give rise to uncertainty because a "line-by-line" comparison is unlikely to be possible. A flexible, principled and outcome-based approach in assessing Third Country systems might be more helpful.

One additional matter that has been brought to the FMLC's attention relates to the uncertainty for system operators (including E.U. and Third Country system operators) as to the scope of the protections afforded by the SFD to the operator's "default arrangements" and any steps taken under or pursuant to them. Such arrangements are put in place by systems to minimize the systemic and other types of risk that arise in the event of a participant appearing to be unable, or likely to become unable, to meet its obligations in respect of a transfer order. They include, but can extend beyond, netting and collateral arrangements and ensure the safe, efficient and effective management of contagion or other risks created by a participant's default or prospective default. Ireland and some other Member States have extended SFD protections to such default arrangements and any action taken under them. The FMLC considers that the financial stability objectives at the basis of the SFD would be enhanced if the SFD were expressly amended to extend its protections to the "default arrangements" put in place by a designated E.U. or Third Country system operator.

Participants in systems governed by the law of a Member State

The SFD lists the participants that are eligible to participate directly in an SFD system and benefit from the protection offered by the SFD. Question 2.1 of the Consultation asks whether the list of currently eligible SFD participants be either limited or extended or otherwise modified. It would be appropriate for the power contained in the second paragraph of the definition of "institution" in Article 2(b) of the SFD, which currently only applies to securities settlement systems, to be extended to payment systems.[2] This would enable the SFD designating body to treat an undertaking participating in a payment system as an institution (and, therefore, a participant) on grounds of systemic risk upon application by the payment system. It would then mean that, in accordance with Article 8 of the SFD, in the event of the insolvency of that undertaking, the law of

the Third Country payment system would determine its rights and obligations arising from, or in connection with, participation in the Third Country payment system.

Additionally, stakeholders have highlighted to the FMLC that the definition of "participant" in Article 2(f) of the SFD appears to have been incorrectly amended by Directive (EU) 2019/879 as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms, so as to remove the original power of an E.U. Member State to treat indirect participants as participants where this is justified on grounds of systemic risk. Reinstating the original provision would provide legal certainty in relation to the treatment of indirect participants of a designated system.

The SFD and other Regulations/Directives

Section 6 of the Consultation poses questions in relation to the interaction of the SFD with other pieces of E.U. legislation applicable in insolvency and insolvency-like proceedings. These include Regulation (EU) 2015/848 on insolvency proceedings (the "**EUIR**") and Directive 2001/24/EC on the reorganisation and winding up of credit institutions ("**CIWUD**"), both of which contain provisions determining which law should apply in the event of the insolvency of an E.U. undertaking. This will generally either be the law of the location of its centre of main interests (COMI) or the law of its Member State of authorisation (depending on which regime is applicable). Should the protections of the SFD be extended to Third Country systems, certain provisions of the EUIR and CIWUD are likely to need to be amended to avoid any resulting legal uncertainty. For example, Article 12(1) of EUIR, refers to the "law of the Member State applicable to that system", and provides an exception to the general rule that the law of COMI should govern the insolvent entity's rights and obligations. It currently only applies in respect of E.U. designated systems by virtue of this reference to Member State law and may need to be extended to Third Country systems. An operative provision (of similar nature and scope to Article 12(1) of EUIR) may need to be added to CIWUD confirming that the rights and obligations of parties to a payment or settlement system remain governed by the law of the system (including a Third Country system designated under a revised or extended version of the SFD). The changes above would address the legal uncertainty that arises on the current drafting by clarifying that provisions of EUIR and CIWUD are not intended to interfere with or otherwise disapply the settlement finality protections for systems designated under the SFD (including Third Country systems).

Extension of the Article 9(2) conflicts of law rule

Finally, Question 7.2 of the Consultation provides space for stakeholders to raise any other issues which may have arisen in the context of the SFD. Article 9(2) of the SFD sets out a conflicts of law rule relating to securities provided as collateral security. This essentially provides that the rights of the holders of such securities (i.e., the collateral-takers) shall be governed by the law of the E.U. Member State in which the register, account or centralised deposit system recording the legal rights to those securities is located. If the SFD is to be amended to include protections for Third Country systems, it would be appropriate in addition to amend Article 9(2) so that it applies in respect of securities the rights to which are legally recorded on a register, account or centralised deposit system in any country or territory (i.e., including a Third Country). Without this amendment, there could be potential uncertainty as to the law that applies for the purposes of determining the rights of collateral-takers in relation to securities legally recorded on a register, account, or centralised deposit system in a Third Country.

I and Members of the Committee would be delighted to meet you to discuss the issues raised in this letter. Please do not hesitate to contact me should you wish to arrange a meeting or if you have any questions.

Yours sincerely,

Brian Gray
FMLC Chief Executive[3]

[1] To the extent that the relevant question does not relate to such rights and obligations, any relevant action taken by the Third Country system should receive such protections from the invalidating, reversing or staying effects of the E.U. Member State's *insolvency law governing the relevant insolvency proceedings as are provided for under* the laws implementing those other protections of the SFD which may be outside the scope of Article 8.

The FMLC would urge authorities to ensure that those protections in Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms ("**BRRD**"), and other E.U. legislative instruments, afforded to systems "designated" under the SFD are also extended to designated third country systems.

[2] Article 2(b) of the SFD provides that

> "institution" shall mean:
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> - a credit institution as defined in the first indent of Article 1 of Directive 77/780/EEC including the institutions set out in the list in Article 2(2) thereof, or
>
> - an investment firm as defined in point 2 of Article 1 of Directive 93/22/EEC (2) excluding the institutions set out in the list in Article 2(2)(a) to (k) thereof, or [...]

[3] The FMLC is grateful to Thomas Donegan (Shearman & Sterling LLP) and Natalie Lewis (Travers Smith LLP) for their assistance in drafting and reviewing this letter.