European Association of CCP Clearing Houses

EACH Note – List of issues to be addressed in the review of the Financial Collateral Directive (FCD) and the Settlement Finality Directive (SFD)

1. Consultation on Financial Collateral Directive (FCD) review

Issue #1 – Clarification of the following concepts included in the FCD

- The consultation asks stakeholders to address the following points:
  1. 'Claims relating to or rights in or in respect of'' – 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 provided separately from its financial instrument?
  2. 'Possession' and 'control' – should these concepts require further clarifications?
  3. 'Good faith acquirer' – should this notion be clarified?
  4. 'Awareness of pre-insolvency proceedings' – need to clarify how the 'awareness' is defined, how can a collateral –taker 'prove' they are not 'aware'?

EACH answer

EACH would like to underline that the above-listed concepts of "claims relating to or rights in or in respect of", "possession" & "control", "Good faith acquirer" as well as "Awareness of pre-insolvency proceedings" should be **flexible** enough to accommodate the Member States' local legislation.

For what concerns the **concepts of "possession" and "control"**, the lack of certainty as to how these apply to numerous commonly used collateral systems, e.g. where the collateral provider is able to withdraw collateral or where collateral remains in an account of the collateral provider. In the U.S., only post-default possession control is assessed, not the ongoing situation of possession or control and whether the level of possession or control suffices, as in the EU. As a result, security financial collateral is essentially close to unused in Europe. The unclear definition of possession and control needs addressing as a high priority and perhaps could be addressed via detail in technical standards. Such terms are not defined further in the FCD and, in most EU jurisdictions, are not legal concepts that could be readily used in relation to assets such as financial collateral. Further clarification could potentially be welcome, to the extent that it helps to provide more detail and harmonise the meaning of "possession" and "control" across Member States and so remove some of the uncertainty faced by market participants.

In relation to **awareness of pre-insolvency proceedings**, EACH would like to emphasise the close relationship between the National Competent Authority (NCA) and collateral takers which are the CCPs, and therefore suggest that awareness could be achieved by having the relevant NCA providing written notice to the CCP. In addition, EACH would like to point out that clarification concerning how a collateral taker can '*prove that he should not have been aware*' would be needed. This test contains a hypothetical element that could potentially lead to different interpretations by the Courts due to the differences inherent to the various national laws, therefore jeopardizing the purpose of the FCD to provide for legal certainty on the enforceability of financial collateral in all EU Member States.

Issue #2 – Recognition of 'close-out netting provisions' in the FCD and its impact on SFD systems

- The consultation asks stakeholders to address the following points:

1. Have Members encountered problems with the recognition/application of close out netting provisions? If so, what were these problems related to (e.g. use within one Member States, cross-border use)? What did these problems concern (e.g. OTC transactions, transactions carried out on an SFD system)? What could be the solution?
2. Do Members see uncertainties related to close-out netting positions due to e.g. the FCD's silence regarding the application of national avoidance actions to such provisions?
3. Do Members consider that there is a need for further harmonization of the treatment of contractual netting in general and close-out netting in particular?

EACH answer

EACH is of the opinion that CCPs should receive protection for close-out netting even in the scenario of a clearing member resolution (i.e. where the clearing member declared to be in resolution has defaulted in the CCP), noting that resolution alone is not ground for default. That protection is already foreseen in Directive 2014/59/EU (BRRD Articles 70.2 and 71.3)[1] and Regulation 2021/23/EU (CCP Recovery and Resolution Articles 55 to 57)[2] which exclude from the power of the resolution authorities to temporarily suspend certain rights (including termination rights) those rights related to the systems or operators of systems designated for the purposes of Directive 98/26/EC, other CCPs and central banks. However, the carve-outs to BRRD do not go far enough, when many CCPs have long-dated derivatives settling many years into the future, given that only obligations of 7 days or fewer maturity are covered. A greater for CCPs would enhance financial stability. A CCP's default rules and default management procedures under EMIR should be legally enforceable in all circumstances. For clarity purposes, this exemption from resolution authorities' powers could also be expressly mentioned in Article 1, paragraph 6 of the FCD, stating that its provisions do not apply to the payment and delivery obligations owed to systems or operators of systems designated for the purposes of Directive 98/26/EC[3], CCPs, and central banks.

In addition, an explicit provision stating that national avoidance provisions are not applicable to close-out netting provisions (including any single amounts that become part of the close-out netting) would strengthen the legal certainty regarding the enforceability of close-out netting provisions.

Issue #3 – Financial collateral

- The consultation asks stakeholders to address the following points:
  1. Do Members think other collateral than cash, financial instruments and credit claims should be made eligible under the FCD?
  2. Should emission allowances and other commodities be added to the definition of financial instruments in the FCD?
  3. For crypto-assets qualifying as financial instrument, would Members 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?

EACH answer

FCD (and SFD) base the protections they offer with reference to cash and/or financial instruments

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN
[2] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R0023&from=EN
[3] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31998L0026&from=EN

(within the meaning of MiFID), therefore excluding financial collateral arrangement involving commodities (in FCD) and transfers of commodities (in SFD) from the benefits of the protections given under these Directives. Note that this refers to the commodities themselves (including warrants, warehouse receipts etc.) and not commodity derivatives (which in most cases should be MiFID financial instruments).

EACH is therefore of the opinion that the **list of collateral eligible under the FCD should be broadened** and cover all assets (e.g. also bank guarantees, emission allowances, commodities and commodities instruments) that are accepted by CCPs as collateral in accordance with EMIR.. EACH is also in favour of **including emission allowances and other commodities** in general in the definition of financial instruments in the FCD. CCPs are aware that this may have implications under the European Market Infrastructure Regulation (EMIR)[4] for what concerns the eligibility of such collateral, and encourage conversations with the NCAs on what could be the best way to reach such aim.

In addition, for what concerns the point on **crypto-assets qualifying as financial instrument**, EACH believes that **the FCD may not be the right place** to set out specifications regarding ownership and provision requirements, as these aspects are governed by the national private law. Regarding the possibility of further specifying possession and control requirements, however, we consider it useful to clarify how these requirements are to be applied to crypto-assets.

Issue # 6: Participants

A final issue concerning the FCD that EACH would like to raise concerns the **participants**. Member States have taken different approaches to defining the entity scope of the FCD as it applies in their jurisdictions, and as CCPs commonly enter into cross-border transactions, this means that they need to analyse the scope of the FCD as implemented in their clearing member's jurisdiction to determine whether they can get the benefit of the FCD's protections. In this context, EACH is of the opinion that a more consistent and homogeneous approach would be welcome.

[4] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0648&from=EN

2. Consultation on Settlement Finality Directive (SFD) review – List of issues

As a general comment, EACH is of the opinion that the SFD could be enhanced to **address specific issues relating to CCPs**, in particular ensuring that **SFD protection**:

- Grants that **all CCPs** could receive **protection under the SFD for their default management rules and procedures if authorised or recognised by the EU**;
- **Is applicable to all participants** (including **clearing members**, **clients** and **indirect clients/participants** whether or not known to the system);
- **Is explicitly extended for both business as usual (BAU) and default management activities of the CCP** as included in its default rules, and to any actions carried out by a CCP in relation to their default rules. The European Commission should be aware that, for CCPs, the protections of SFD may apply only to a relatively narrow part of their business – dealing with transfer orders and security collateral – since the SFD does not expressly include any provisions relating to the entry into of non-securities contracts (e.g. derivatives), the management of open derivatives contracts or their risk management, the taking or netting of collateral received by way of title transfer (where the SFD could be interpreted as ambiguous and different Member State interpretations exist) nor all aspects of the default management of CCPs under Article 48 of EMIR. Since EMIR contains only sparse provisions concerning insolvency protections, which do not apply to third country systems, the protections of the SFD must be extended such that they are not **limited to entering transfer orders/taking collateral security**, but should be extended also **include all default management activities to be closer aligned with EMIR Article 48**, including but not limited to hedging on the clearing member's account, rolling contracts, porting, auctions and realizing or transferring collateral and contracts, and also to third country as well as EU CCPs. Furthermore, protection should be extended to activities in relation to any assets (not just cash and securities). At present, protection is only granted for transfer orders entered on the day of insolvency, if 'carried out' on that day, not after. If a transfer order is processed on the next day, it may therefore not be protected. This constitutes a problem for default management (if not otherwise protected) and also for settlement cycles longer than T+0 (and issues similar to this were considered as part of the Swedbank case).

  In the event of insolvency of a clearing member of the CCP, CCPs may issue new settlement instructions that need to be processed by the CCP or by a settlement or payment system (for instance, cancellation of previously issued settlement instructions or new settlement instructions required within the close-out netting procedure in the CCP). The possibility to accept and process new transfer orders after the commencement of an insolvency proceeding (not necessarily on the same business day) against a participant of a system, in the context of CCP default management procedures, could be protected by the SFD. It appears that in some EU Member States transfer orders from the CCP to the Securities Settlement System (SSS) cannot be cancelled or reinstructed if needed (e.g. in case the CCP starts a buy-in procedure). This could be addressed if there was a change to the SFD at EU level that harmonises the protection of CCP default management procedures (article 48 EMIR) and, consequently, the transfer orders that the CCP might issue or process within those default management measures.

To address the issue above, EACH suggests that Art. 3 SFD be extended so that there is a paragraph which contains roughly the following content: transfer orders which are issued or entered into a system by a central counterparty after the moment of the opening of insolvency proceedings of a participant in the system operated by such central counterparty, and that are carried out by the central counterparty in accordance with Article 48 of Regulation (EU) No 648/2012, shall be legally enforceable and binding on third parties.

- **Is not limited to cash and/or financial instruments** (within the meaning of MiFID) meaning that financial collateral arrangement involving commodities (FCD) and transfers of commodities (SFD) cannot benefit from the protections given under these Directives. Note that this refers to the commodities themselves (including warrants, emission allowance, warehouse receipts, etc.) and not commodity derivatives (which in most cases should be MiFID financial instruments). Commodities and transfers of commodities should also be protected under the scope of SFD and FCD.
- **Is clarified to incorporate any challenging of the provision of collateral itself** - As outlined in the foregoing, Art. 9 SFD which states that "the rights of a system operator or of a participant to collateral security provided to them in connection with a system [...] shall not be affected by insolvency proceedings" is to be interpreted so that it protects such provision of collateral also against any challenging of the provision of collateral itself (for example, based on *actio pauliana* rules) (see Ruzik, in: Schulze/Lehmann, European Financial Services Law, Art. 3 SFD, para. 7). Moreover, this provision should be interpreted in such a way that it protects the provision of collateral also in the case of initiation of administration or liquidation proceedings[5] that are not insolvency proceedings per se, but could have a legal effect in relation to the collateral or contributions to the clearing fund. Such protection should be provided for even if open liquidation or other legal measures have been initiated before the default of any clearing member. To further strengthen the legal certainty, it would be recommendable if that effect is directly set out in the wording of Art. 9 SFD. We propose that the scope of the protections of Art. 9 SFD be clarified so that it expressly includes also realisable assets provided on a title transfer basis.

Issue #1 – Participation in systems governed by the law of a third-country. Points to be addressed:

- The consultation asks stakeholders to address the following points:
  1. Should EU institutions that participate in third-country systems be protected by the SFD?
  2. Should Members consider necessary to conduct an assessment on whether the applicable third-country law provisions are comparable to the SFD, how do Members see the following possible criteria for such assessment? Statements to which respondents can respond include:
     a. SFD protection should only be extended to third-country systems, if the third country extends protections towards SFD systems
     b. Systemic importance of the third-country system should be prerequisite
     c. Only systems that are as strict as the SFD regarding the provisions about direct

[5] With administrative proceedings we intend any administration or bailiff proceeding made by the bailiff, court or any administrator/regulator.

participation should be eligible for the designation

d. Only systems that are as strict as the SFD regarding the provisions about indirect participation should be eligible for the designation
e. No discrimination between EU institutions and other institutions should be made by the third-country system
f. The country of establishment of the system operator as well as the country where the infrastructure is located, maintained and/or operated should be considered
g. In case the scope of the SFD was to be extended to EU institutions participating in third-country systems: Should the scope be extended to EU institutions participating in third-country payment and security settlement systems

EACH response

EACH is of the opinion that **all CCPs** could receive **protection under the SFD for their default management rules and procedures if authorised or recognised by the EU**. However, this should be achieved by **extending to third country systems the protections of the SFD**, not merely by protecting EU participants in those systems. We would like to underline in this regard that **all aspects of the default management process**, in particular those involving the **property of the defaulting clearing member pre- or post- insolvency**, including the default actions (including porting, close-out netting, collateral enforcement, hedging or otherwise dealing with contracts) and the application of the CCP's default waterfall, **should be included in any SFD protections**. It is also crucial to point out that **close-out netting and collateral enforceability** form an essential part of the default management procedure of a CCP as required under EMIR (or equivalent laws), and it is essential that they are **included within any protections under the SFD** for the default management process of the CCP.

At the moment there are differences between Member States concerning whether the applicable third-country law provisions are comparable to the SFD. EACH suggests **considering reviewing** what could be **most efficient and robust approach**: a determination at EU level or at Member State level, having regard to the existing regimes across Member States for the designation of systems. **In case an EU-level determination is adopted**, EACH believes it could be done as **part of the EMIR recognition process.**

Furthermore, as previously mentioned, for what concerns **transfer orders and other aspects of the SFD**, if the EU decides to adopt an equivalence regime at EU level, it should factor in that:

i. the third country system includes clear rules specifying the kinds of transfer orders which arise in their systems and their timing;
ii. those rules are enforceable under the system's governing law; and
iii. third-country law applicable to the system does not discriminate between EU participants and third-country participants (subject to those differences which arise due to different definitions or solutions for similar concepts under applicable laws, such as different account segregation models in the US and EU).

In addition, we believe that the scope should be extended to both third-country payment and security settlement systems, as there is no reason to differentiate between the two.

Issue #2 – Designation of a third-country system if the scope was to be extended. Points to be addressed

- The consultation asks stakeholders to address the following points:
  1. Should the assessment for designation of a third-country system be done on a case-by-case basis?
  2. Should a regular evaluation be required whether the requirements for designation are still met?

EACH response

As mentioned above, we suggest **considering reviewing** what could be most efficient and robust approach, i.e. a determination at EU level or at than at Member State level, having regard to the existing regimes across Member States for the designation of systems. Should an EU-level determination be adopted, we believe it could be done as **part of the EMIR recognition process**.

Issue #3 – Participants in systems governed by the law of a Member State. Points to be addressed:

- The consultation asks stakeholders to address the following points
  1. Should the list of currently eligible SFD participants be either limited or extended or otherwise modified?
  2. Should participation in an SFD system be limited to legal persons?
  3. Should e-money and payment institutions be included in the list of currently eligible SFD participants? If so, what kind of risk should be assessed (IT, operational, credit, other risks)
  4. Should operators of EU payment systems that are not designated under the SFD be added to the list of participants covered by the SFD?
  5. What do Members think of limiting the number of eligible SFD participants by replacing or complementing the current list of eligible participants by an approach that is based on a risk assessment for participants?

EACH response

It should be taken into consideration that not all entities falling under a CCP clearing obligation under EMIR or entities which would like to participate in the CCP clearing are eligible system participants under the SFD or the respective local laws.

In order to improve the existing situation, we suggest that:

- The **list of entities** that are covered by the SFD protection be extended to cover **entities that do not themselves take rights and obligations vis-à-vis the system / the system operator, but fulfil tasks that are closely related to the functioning of the system**, e.g. CSDs (in particular, as CSDs might in the future fall outside of the definition of an 'institution' due to their CSDR license) and other entities that act as settlement agents / third party provider of collateral etc. on behalf of system participants.
- All financial counterparties and non-financial counterparties which exceed the clearing threshold under EMIR should be capable of being participants in designated systems which are CCPs

- The SFD make it clear that it also applies to the interaction between the system / system operator and **clients and indirect clients** of clearing members which, for example, may directly provide collateral to the CCP or which may directly receive collateral from the CCP (see Article 48 (7) of EMIR for the latter).

Issue #4 – Protections granted under the SFD vis-à-vis collateral security

- The consultation asks stakeholders to address the following points:
    1. Should the protection in Article 9(1) of the SFD be extended to clients of participants in an SFD securities settlement system in the event of the insolvency of that participant? If so, should the client:
        a. Be known to the system operator?
        b. Have to fulfil criteria that are predefined by the system operator?
        c. Have its own segregated account?
        d. Provide collateral security to secure transactions exceeding the threshold under EMIR?

EACH answer

EACH is of the opinion that it would be **helpful for indirect participants to benefit from protections** if this **furthers protects the CCP's default management rules and procedures** (e.g. porting, transfer of assets and direct return or leapfrog payments). Also, the protection could be extended to protect clients (or other third parties) directly providing collateral to a CCP (i.e. fulfilling the margin obligation of the clearing member). The protection should therefore be the same as if the clearing member had provided it. However, CCPs should not be responsible for adding indirect participants to their systems where those participants are not known to or identified to the CCP, e.g. customers in omnibus accounts.

Furthermore, **porting** and also any action that might impact *in rem* rights – such as the transfer of margin securities to a transferee clearing member under article 48 of EMIR – should be expressly protected from insolvency law (for both EU and third country CCPs), and there should be no requirement for permission from the defaulting clearing member or its administrator to do so. Requiring the naming/knowledge of the identity of the indirect participant may mean any such provision does not benefit most CCPs.

Issue #6 – Settlement finality under the SFD

- The consultation asks stakeholders to address the following points:
    1. Does the settlement finality and notification about insolvency proceedings under the SFD raise the following concerns?
        a. The legal duty for an SFD system to specify the moments of entry into the system and irrevocability as well as where settlement is both enforceable and irrevocable should be clearly stipulated in the SFD. We could confirm a rules based approach would be sufficient. Important to capture default and non- default situations, acknowledging that CCPs may carry out default management over a longer period than one day.

b. The settlement finality provisions of the SFD should accommodate the specificities of clearing systems both under business-as-usual and market stress conditions more clearly. Agreed.
c. A provision in the SFD for ensuring that the moment of settlement finality is identical in relation to both the cash and securities legs of a transaction settled on the basis of 'delivery-versus-payment' is needed.

EACH Answer

EACH believes that the SFD should clearly stipulate that a system operator should also be immediately notified about the opening of insolvency proceedings (in addition to an Authority chosen by the Member State, the ESRB, ESMA and other Member States).

In addition, there should be explicit protection for designated systems (whether domestic or third country) when they enter into risk reducing or offsetting trades as part of default management to ensure that such transactions (when entered into for the defaulters' account) are protected from insolvency law, even if those trades are not performed on the same day when the insolvency has been declared.

Issue #7 – The SFD and other Regulations/Directives

- The consultation asks stakeholders to address the following points:
  1. Is there any (insolvency or other) legislation where provisions are not sufficiently clear in terms of their interaction with the SFD or the other way round (e.g. Insolvency Regulation, Second Chance Directive, BRRD, CCP RR, PSD 2)

EACH answer

As noted in relation to the FCD, EACH believes that there should be a clear protection of CCP default rules and procedures even in the event of a resolution scenario where a clearing member has defaulted (other than as a result of its own resolution process). It should be noted that protection for any actions must extend beyond the first day of insolvency of the member as many CCPs default management processes will take longer than one day. Relevant protections under BRRD should also include all obligations of CCPs, including long-dated derivatives, and not merely short-term transfer order settlements.

In addition, we would like to refer to Art. 8 SFD which refers to the law governing the system in respect of rights and obligations arising from or in connection with the participation of a participant in the system in the event of an insolvency. The provision aims to enable the system to rely on its local insolvency laws even in case of an insolvency of one of its foreign participants. However, Art. 8 SFD limits the reference to the system law to "the relevant rights and obligations arising from, or in connection with, the participation of the participant in the system". Since CCP systems include elements which are broader than the SFD system as it relates to transfer orders, in some jurisdictions it seems to be unclear which exact rights and obligations fall under this category. The protections of the SFD for designated systems and collateral should apply to all the systems of a CCP and all the collateral that it takes, regardless of the extent to which this applies to its designated system versus the CCP system as a whole. Otherwise, there would remain a risk that an EU or foreign court, authority, bankruptcy trustee or liquidator would interpret Art. 8 narrowly, i.e. without involving all

the rights and obligations stipulated under the respective clearing rules and default management as required under EMIR. We would therefore find it beneficial for CCPs if Art. 8 was sharpened in such way that it made clear reference to the default management procedures of a CCP according to article 48 EMIR and hence include all actions a CCP would impose on a defaulted participant.

Finally, EACH would like to stress that a single European insolvency framework, giving the necessary derogations from national insolvency, would provide CCPs with the sound, robust and enforceable legal framework required to carry out their main activity of managing the default of their participants when an insolvency event is the ground for such default. It is important bearing in mind that EMIR requires CCPs (Article 48.4) to verify that their default procedures are enforceable. While in some Member States there is a view that EMIR achieves this, that is far from being the case in every jurisdiction. This means that, in practice, CCPs rely on specific national legislation and/or the national implementation of EU-level Directives such as the FCD and SFD. Some CCPs therefore consider it necessary to take a separate (and relatively complex) insolvency opinion in every EU jurisdiction where clearing members are incorporated, and in some jurisdictions relevant legal opinions remain most unsatisfactory or are subject to significant qualifications. Having a single European insolvency regime would permit achieving the essential and required legal certainty with regards to CCPs default procedures (Article 48.4 EMIR) and would contribute to the reduction of the cost of doing business in the EU.