

International Swaps and Derivatives Association, Inc.
COLLATERAL LAW REFORM GROUP

ITALY

COUNTRY REPORT

Supplement to
*Collateral Arrangements in the European Financial Markets:
The Need for National Law Reform*

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Summary report on the legal framework for collateral arrangements for financial activity

Summary of the legal analysis under the laws of Italy applicable to collateral arrangements intended to secure financial trading activity in relation to privately negotiated derivative transactions, securities trading, securities repurchase transactions, stock lending and similar financial transactions in the wholesale financial markets. It is assumed that at least one of the parties involved is a financial institution (credit institution or investment firm) and that the collateral involved is cash, in euros or some other freely available currency, and/or fungible securities listed on a stock exchange or recognised market and held in immobilised or dematerialised form in a clearing system ("Fungible Securities"). References to "collateral" below indicate cash and Fungible Securities, unless otherwise specified.

This summary was prepared for the purpose of identifying possible areas of uncertainty or commercial impracticality arising under the laws of Italy in relation to collateral arrangements. It is not intended to be a definitive summary of the legal position relating to collateral in Italy and should not be relied on as such.

The position is stated as of December 1999.

This summary, prepared by the Collateral Law Reform Group, does not necessarily represent the views of ISDA or any of its members. It is a subjective assessment of the position in Italy and is simply intended to encourage debate and discussion of the relevant issues.

KEY POINTS FOR CONSIDERATION FOR ITALY

- (1) The owner of a share in a pool of Fungible Securities would have absolute title to an interest in the assets.
- (2) The *lex loci* of Fungible Securities held through an account in a clearing system is the place where the securities are physically held or where the relevant records are kept.
- (3) According to the conflicts of law rules, the *lex loci* governs the formal requirements to be met in order for a security interest in Fungible Securities to be enforceable against third parties, whereas the law of the agreement governs the creation and perfection of a security interest in Fungible Securities.
- (4) If security assets are held by a third party bank or custodian the security interest must be notified to or acknowledged by the third party. Please note that in case of dematerialised Fungible Securities, the law No. 213 of 24th June, 1998, states that a security interest over dematerialised securities can be created only by book entry transfer into a specific account opened with an intermediary.
- (5) No official registration of a security interest with any state agency is necessary.
- (6) Under a regular pledge the secured party cannot use security assets as its own property, unless otherwise agreed with the pledgor.

- (7) Formal procedures apply to enforcement of a security interest but may be partially varied by agreement.
- (8) Enforcement of a security interest may not be delayed and is not stayed on insolvency.
- (9) Title transfer arrangements may be recharacterised as an irregular pledge. This means that certain of the rules relating to pledges apply. An irregular pledge is, however, in substance a transfer of title.
- (10) Close-out netting under an ISDA Master Agreement is enforceable.
- (11) Contractual set-off is enforceable on insolvency.
- (12) Top-up collateral may be avoided as a preference, in certain circumstances set out in the law No. 267 of 16th March, 1942 (the “**Italian Bankruptcy Law**”).

1. Do the laws of Italy deal clearly with the nature of a participant’s interest in a holding of Fungible Securities?

The nature of a participant’s interest in a holding of Fungible Securities is dealt with in Legislative Decree no. 58 of 24th February, 1998 (the “**Financial Law**”) and in CONSOB Regulation n.11768/98 of December 1998.

2. How would such an interest be characterised under those laws?

Under the provisions of Article 85 of the Financial Law, Italian financial instruments traded on an Italian regulated market no longer take the form of paper certificates but instead are constituted by book entries in a centralised depository (currently Monte Titoli or Banca d’Italia in the case of Italian government bonds) (a “**Central Depository**”) allocated to securities accounts opened by financial intermediaries such as banks and other authorised financial intermediaries (an “**Intermediary**”).

Italian financial instruments for the purposes of the Financial Law (and the relevant implementing legislation) are shares of companies listed on the Italian Stock Exchange, bonds listed on the Italian stock exchange, Italian government securities and units in investment funds.

The owner of securities must enter into a depository agreement with an Intermediary, granting the Intermediary the power to (i) sub-deposit the received securities with the Central Depository, and (ii) transfer all or some of the rights attaching to the securities in accordance with the owner's instructions. The deposit of securities with the Central Depository is characterised by law as a “regular deposit” (*deposito regolare*). The securities are fungible but ownership is not transferred to the Central Depository. In fact, both the Intermediary and the Central Depository do not themselves have the right to dispose of the securities, but must each be considered the depositories in respect of the true owner of the securities. It follows that a financial intermediary has the same rights against the Central Depository as its client has against the financial intermediary (that is, the rights of a depositor against a depository).

3. How would the location of Fungible Securities be determined under the laws of Italy?

The location of securities in physical certificated form is wherever the physical certificates are located. The location of dematerialised securities is the place where the official record of

such securities is kept. The Italian parliament is in the process of implementing European Directive 98/26/EC of May 19, 1998 (the “Settlement Finality Directive”) by legislative decree. Once the legislative decree comes into force a participant’s rights to Fungible Securities held in a depository located in an EU Member State will be governed by the law of the system.

4. Under Italy’s conflict of laws rules, what law would govern:

(a) the characterisation of a person's holding of Fungible Securities?

The law of the location of the collateral.

(b) the creation of a security interest in cash or Fungible Securities?

Article 51, second paragraph, of Law No. 218/95 states that the governing law of any security agreement will determine whether a pledgee has obtained a valid security interest in the property of the pledgor.

(c) the formal validity or perfection of a security interest in cash or Fungible Securities?

The law of the location of the collateral.

(d) the effectiveness and formal validity of a transfer of title to Fungible Securities?

The law of the location of the Fungible Securities. Under Italian law, the law governing a collateral arrangement based on a transfer of title is the governing law of the agreement itself. Should an Italian court recharacterise the transfer of title under such an agreement, it would recharacterise it as an irregular pledge (“*pegno irregolare*”). An irregular pledge effects a transfer of title to the collateral. Note that, although in substance a transfer of title, an irregular pledge entails certain formalities of the type applicable to regular pledges where the relevant collateral assets are located in Italy.

5. What types of security interest may be created under the laws of Italy in:

(a) cash?

Irregular pledge.

(b) Fungible Securities?

Regular and/or irregular pledge

Where more than one type of security interest is possible, please indicate which type(s) would typically be used for collateral arrangements involving cash and/or Fungible Securities, and why.

The security interest typically used for collateral arrangements involving cash or Fungible Securities is the *irregular pledge*.

Under Italian law, a pledge can be granted over moveable fungible or non-fungible assets, due and payable obligations and intellectual property rights.

When the collateral receiver is a bank, a pledge can be granted over cash or securities that have not been individually identified or of which the bank has been authorised to dispose. This is defined as an irregular pledge (*pegno irregolare*) as it creates a transfer of title. Although there is no specific legislation to this effect, the prevailing view in the legal profession is that an irregular pledge can also be created in favour of creditors other than banks.

Under Italian law a pledge creates a security interest and an irregular pledge operates as a transfer of title. The principles governing the creation and perfection of a pledge also apply to irregular pledges.

In order for a pledge to be created, the pledged assets or the documents conferring the exclusive power to dispose of such assets must be delivered to the pledgee or to a third party designated by both the pledgor and the pledgee, in such a way as to make it impossible for the pledgor to dispose of the assets without the permission of the pledgee.

The general trend in court decisions is that a valid and perfected security interest cannot be created over after-acquired property or over an undetermined pool of assets. If the encumbered assets, although specifically described in the collateral agreement, are not owned by the pledgor at the time the pledge is created, the collateral agreement would at most be given effect as a promise to pledge or a preliminary pledge that could be specifically enforced by the secured party. The secured party will be vested with a perfected security interest over the relevant assets only when these have been actually acquired by the pledgor and physically delivered to the secured party or to a third party custodian. As a consequence of the above, a security interest in after-acquired property cannot be validly perfected under Italian law.

On the same basis, some judicial precedents have held a pledge inadmissible where the amount of the secured exposure and, accordingly, the amount of collateral required are not pre-determined or cannot be easily determined in advance. There is an argument (which does not appear to have been found persuasive by the Courts), that pledges intended to secure a pledgor's obligations where the amount of the obligation cannot be determined in advance, or where the amount of the collateral is not identified, would be valid at least between the parties, although not *erga omnes*: that is, the secured party, would be vested with a right of retention over the pledged assets and, therefore, could withhold those assets until the debtor has duly fulfilled any secured obligation, provided, however, that the secured party would not be given any priority *vis-à-vis* other creditors of the pledgor.

6. In relation to each of these types of security interest, describe briefly any filing, registration, notification, notarisation or other formal requirement necessary to ensure validity of (or "perfect") the security interest? In relation to each type of security interest, please indicate the consequence of failing to comply with the relevant requirement.

Pursuant to art. 2787, third paragraph, of the Italian Civil Code a pledge agreement has to be executed in writing, to bear a "certain date", and contain sufficient detail as to the nature of the secured obligations and the pledged assets. According to the provisions of Article 2704 of the Italian Civil Code, the requirement for the document to bear a certain date is fulfilled if the date of the relevant document is identified by its notarisation or also by other evidence, that is by evidence drawn from sources exterior to the document itself, such as writings, book entries in a register or by the contents of the document being the result of a public act, or any fact which establishes the prior creation of the document. In order for a pledge to be perfected, the pledged assets or documents conferring exclusive powers to dispose of such assets must be delivered to the secured party, or to a third party designated jointly by the

pledgor and the secured party. Furthermore, certain formalities have to be followed in order to perfect the pledge and make it effective *vis-à-vis* the issuer (in the case of securities) and other third parties, depending on the nature of the pledged assets. Please note that such formalities apply to both a regular and an irregular pledge.

If the parties fail to comply with the formalities set out by Article 2787 of the Italian Civil Code, the pledge would not be enforceable against third parties. This means that the secured party would not be given any priority *vis-à-vis* other creditors of the pledgor.

Pledge of an Account

Notice of the pledge must be given to, or the pledge must be acknowledged by the person with whom the account is held; a dated acknowledgement of the pledge is sufficient to establish notice. Please note that, under Italian law, a pledge created over the fluctuating balance of a bank account is likely to be characterised by an Italian Court as an attempt to create a “*pegno omnibus*”. Current judicial authority holds that this particular kind of pledge is void because it does not comply with the formal requirements applicable to pledges set out in Article 2787. In particular such a pledge does not sufficiently detail the secured obligations and the pledged assets.

Pledge of Certificated Securities

If the securities are represented by certificates and are in registered form, notice of the pledge must be recorded on the relevant certificate and in the corresponding register. The notice on the certificate may be replaced by endorsement of the certificate with the words “as security” or equivalent.

Pledge of Dematerialised Securities

The pledge must be recorded as a book entry in the relevant collateral account opened with the intermediary and registered in the securities' register of the issuer.

Article No. 34 of the Legislative Decree No. 213/1998 provides that the creation and perfection of a security interest or transfer of title over dematerialised financial instruments negotiated on an Italian Regulated market, may be effected exclusively through a book entry in the correspondent securities book of the Intermediary that holds the account with the Central Depository (see above under No. 2 above).

There are two different types of account: (i) accounts that allow the account holder to create a security interest over individual securities registered therein; (ii) accounts that allow the holder to create a security interest over the value of all the financial instruments registered therein.

Legislative Decree No. 213/98, The Financial Law and CONSOB Regulation No. 11768/98 provide that the Intermediary, within five days of any request of the registered owner or any collateral receiver, must issue a certificate setting out details of the registered dematerialised securities.

7. **In relation to each type of security interest, indicate whether the collateral receiver is entitled to use the collateral as though it were the absolute owner of the collateral, including the right to sell, lend or re-pledge (rehypothecate) the collateral to a third party.**

Under a regular pledge of collateral, the pledgor remains the owner of the assets transferred to the secured party although he no longer has possession of them, as a result of transfer to the secured party.

The secured party has an obligation to safe-guard the assets given to him under the pledge and is responsible for any deterioration or loss of them and cannot use the assets given to him under the pledge without the prior consent of the pledgor and cannot re-pledge them or let third parties use them. If this happens, the assets subject to the pledge can be distrained by injunction.

An irregular pledge overcomes the above difficulties. This type of pledge may apply when cash, commodities or securities are given as collateral and enables the pledgee to dispose of them (for example, sell, lend or repo them) (see answer to Question 9 below). In this case, ownership of the assets passes to the secured party which has an obligation to return equivalent assets to the pledgor when he receives payment. However, any payment and the value of the collateral can be netted so that the secured party only has a duty to return the resulting difference.

8. **Briefly describe the enforcement procedures for each type of security interest commonly used for collateral in relation to financial activity. For example, is court approval required before the security interest may be enforced and/or is some form of auction procedure required. Indicate any practical difficulties typically encountered and also the relative efficiency and speed (or lack of same) of such procedures. Comment in particular on the possibility of a stay or freeze in the event that the collateral provider is subject to formal insolvency proceedings of any type.**

The Italian Civil Code and the Italian Code of Civil Procedure lay down rules for the enforcement of security interests. These involve the sale of the collateral and do not permit the secured party either to foreclose on the assets or to appoint a receiver over them. To the extent the proceeds of enforcement are insufficient to satisfy the debtor's outstanding debt *vis-à-vis* the secured party, any unsatisfied claim will rank *pari passu* with other unsecured creditors. Moreover, Italian law prohibits any automatic forfeiture of collateral to the creditor upon the debtor's default.

- (a) In the case of a **regular pledge** and in the event of the debtor's default, the secured party has two options under a pledge: (a) he may sell the pledged assets and satisfy his claim out of the proceeds of sale; or (b) he may file a petition with a competent court requesting the transfer of the assets to him. In this case, if the pledged assets do not have a market value, the court will order a valuation of the pledged assets, to be carried out by an independent expert appointed by the Court. According to judicial precedents, the court must transfer pledged assets to the secured party if the secured party requests this; the length of the proceedings, however, is quite unpredictable. If option (a) is selected, the secured party may either follow the general procedures for forced sales, which provides for a court-supervised auction, or can choose the following special procedure:

- the secured party must serve the pledgor and the debtor (if different from the pledgor) with a notice requesting payment of the outstanding amounts and

containing a warning that the pledged assets will be sold pursuant to Article 2797 of the Civil Code;

- within 5 days of receipt of such notice, the debtor and/or the pledgor may challenge the sale by filing a petition with a competent court. Any challenge will suspend the sale process until a decision is given by the court. If the debtor and/or the pledgor want to challenge the secured party's right to sell the pledged assets on substantive grounds, they must initiate ordinary proceedings (and the enforcement proceedings shall not be automatically suspended);

If neither the debtor nor the pledgor challenges the sale, the secured party may proceed to sell the assets (1) through a public auction, to be carried out under the supervision of a court clerk; or (2) if the pledged assets have a market value (as in the case of securities), through an authorised broker.

The parties may, agree upon a different procedure for the sale of pledged assets, in the pledge agreement or elsewhere. In the case of securities, for example, they may agree to appoint a bank as agent for sale of the pledged securities or agree that they be sold by the custodian or even by the secured party, provided that in doing so the secured party acts in the best interest of the pledgor. However, whether or not there is a right to enforce under the pledge in certain circumstances, third-party creditors of the pledgor may seize pledged assets in spite of any such agreement and require that the general procedures for forced sales rather than any privately negotiated procedures be followed.

Since any action by third party creditors would almost certainly be considered an event of default with respect to the underlying secured transaction, the secured party will be entitled, as a preferred creditor, to participate in the distribution of the proceeds of sale of the assets but cannot prevent the sale.

In the event of the insolvency of an Italian collateral provider, in accordance with general principles of law and the provisions of Article 53 of the Italian Bankruptcy Law the pledgee must file a petition with the bankruptcy Court asking permission to sell the pledged assets. The sale must be effected in compliance with the procedure described above for forced sales.

- (b) In the case of an **irregular pledge**, the collateral receiver acquires title to the pledged assets, and can therefore dispose of them at any point.

Upon creation of an irregular pledge, title to the pledged assets is transferred to the secured party subject to a duty of the collateral receiver to return cash and/or the same quantity of equivalent securities to the debtor upon expiration, unless the debtor defaults.

If the debtor defaults the secured party may set off the secured exposure against the pledged assets, in which case the secured party has only to return the balance, if any. The return of the balance is essential because, under Italian law, an agreement is void if it provides that in case of default, title to secured assets passes to the creditor irrespective of whether the value of those assets exceeds the amount of the credit (a “foreclosure agreement” or *patto commissorio*).

In the event of the insolvency of an Italian collateral provider, the collateral receiver must file a petition in the bankruptcy proceedings allowing it to be recognised as a preferred creditor and to be free to set off its exposure against the transferred assets.

Some judicial precedents state that the pledgee will be entitled to set off the secured exposure against the pledged assets and return the balance without filing any petition with the bankruptcy court. There is also established judicial authority, supported by the opinion of some academics, that if the secured party is a bank, a transfer of securities or cash can be characterised as an irregular deposit. As a consequence, set off would be possible even if the formalities prescribed for the perfection of an irregular pledge are not fulfilled.

- (c) Depending on the insolvency proceedings applicable to the Italian pledgor, there may be a freeze on payments. Particularly in the case of the Extraordinary Administration of Banks, Financial Companies and Authorised Intermediaries in certain exceptional circumstances, and subject to the authorisation of the Bank of Italy, the extraordinary administrators may suspend payments of the debts of the relevant entity for a maximum period of three months (see below under Question 11).

9.a. In relation to local law collateral arrangements based on transfer of title, please indicate whether there is a risk that the courts of Italy would recharacterise the transfer of title as the creation of a form of security interest? If so, please give some indication of the degree of that risk (for example, very low, low, medium, high, very high). Please indicate the consequences of such a recharacterisation.

Given the lack of a specific provision for this kind of arrangement, an Italian Court would investigate the real intention of the parties entering into collateral arrangements governed by Italian law and based on a transfer of title and could re-characterise the agreement as constituting an irregular pledge. In our opinion there is a high risk of re-characterisation. Nonetheless, it is important to bear in mind that an irregular pledge is, in substance, a transfer of title.

The consequence of recharacterisation as an irregular pledge rather than an outright transfer of title is that certain formalities applicable to the perfection of pledges apply. If asked to consider the question, an Italian Court would need to verify that the security interest created under the collateral arrangements was consistent with the provisions of the Italian Civil Code relating to the formalities required for perfection of an irregular pledge and to determine whether a security interest enforceable against third parties had been created (see Question 6 above).

In the event of a failure to comply with such formalities, the pledgee would not be treated as having any priority *vis-à-vis* the other creditors of the pledgor.

9.b. If the agreement is governed by a foreign system of law that does not recharacterise, would the risk of recharacterisation under domestic law still be present?

Under Italian law, the law governing a transfer of title or the creation of a new pledge by an Italian incorporated counterparty is the governing law of the collateral arrangement. Assuming that the choice of law under the collateral arrangement is a valid and proper choice of law, the Italian courts would recognise the validity of a transfer of title or creation of a pledge to the extent that transfer of title or pledge was valid under the governing law of the collateral arrangement. However, please note that, both for a transfer of title and for the creation of a pledge, the necessary formalities under Italian law must be followed if the assets

are held in Italy. There is a low risk of re-characterisation of collateral arrangements as an irregular pledge if the relevant assets are not held in Italy.

If an Italian Court recharacterises a foreign law pledge granting the pledgee the power to dispose of the pledged assets (for example, as in the case of the ISDA Credit Support Annex under New York law), this would be likely to be regarded as an irregular pledge, that is, in effect a transfer of title to the collateral.

As a consequence of any recharacterisation, the Italian Courts would need to verify that the security interest created under the collateral arrangement was consistent with the provisions of the Italian Civil Code relating to the formalities required for perfection of an irregular pledge and to determine whether a security interest enforceable against third parties has been created (see Question 6 above).

In the event of failure to comply with such formalities, the pledgee would not be treated as having any priority *vis-à-vis* the other creditors of the pledgor.

- 10. Is close-out netting, for example, under a 1992 ISDA Master Agreement, enforceable under the laws of Italy? If so, but subject to certain limitations (for example, as to the nature of the counterparty or types of transaction included within the netting), please indicate briefly what those limitations are.**

Close-out netting is enforceable under the laws of Italy. For a discussion of relevant limitations and qualifications, see the netting opinion provided to ISDA by Ughi e Nunziante of October 1998.

- 11. Is contractual set-off and/or insolvency set-off enforceable in the event of formal insolvency proceedings in the courts of Italy in relation to a counterparty organised in Italy? Please indicate the answer in relation to each type of formal insolvency proceeding (including rehabilitation or reorganisation proceedings such as administration or *redressement judiciaire*) possible in Italy in relation to a corporate entity (including a financial institution). Comment in particular on the possibility of a stay or freeze in the event that the collateral provider is subject to formal insolvency proceedings of any type.**

See the netting opinion provided to ISDA by Ughi e Nunziante of October 1998.

- 12. Would the exercise of netting or set off rights under a title transfer collateral arrangement be vulnerable to the rights of third parties in the event of the insolvency of the collateral giver? For example, would it be possible for the collateral giver to disrupt (deliberately or inadvertently) the netting or set-off by assigning to a third party creditor its right to redelivery of equivalent collateral under the collateral arrangement? Could that right to redelivery be attached by a third party creditor of the collateral giver free of the collateral taker's netting or set off rights under the collateral arrangement?**

The issues relating to the ability of any third party claimants to disrupt set-off and netting are complex and not easily discussed in a summary of this type.

- 13. In relation to mark-to-market collateral arrangements, is there any risk under the preference (or similar) rules of Italy that "top-up" deliveries of collateral would be vulnerable to avoidance if made during a relevant period prior to the insolvency of the collateral giver?**

There is significant legal risk relating to the effect of preference periods under the Italian Bankruptcy Law in relation to mark-to-market collateral. In fact, "top-up" deliveries of collateral could be revoked in the event an Italian Counterparty were declared bankrupt within a period of 12 to 24 months from the date of delivery. The pledgee would have to return the pledged securities to the bankruptcy receiver, and its exposure, as a consequence, would become an unsecured claim.

- 14. Please add any additional comments on the general legal framework for collateral arrangements under the laws of Italy, whether based on creation of a security interest or on title transfer, highlighting any difficulties that should be addressed in any project for collateral law reform in Italy.**

Express provision for title transfer collateral arrangements should be incorporated into Italian law to permit more efficient use of collateral, although similar results can be achieved under existing law by using an irregular pledge. There are, however, problems in relation to preference periods and top-up deliveries of collateral. Reform of these areas will require a thorough review of the whole subject.

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