

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

SPAIN

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 Spain 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 held listed on a stock exchange or recognised market and 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 Spain in relation to collateral arrangements. It is not intended to be a definitive summary of the legal position relating to collateral in Spain 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 Spain and is simply intended to encourage debate and discussion of the relevant issues.

KEY POINTS FOR CONSIDERATION

- (1) The owner of a share in a pool of Fungible Securities would have absolute title to the assets.
- (2) The *lex loci* of Fungible Securities held through an account in a clearing system is the place where the assets are (physically) held.
- (3) Conflicts of law rules would apply the *lex loci* to the transfer of Fungible Securities and the creation and perfection of a security interest in Fungible Securities but are unclear with respect to a holding of Fungible Securities.
- (4) If security assets are held by a third party bank or custodian the security interest must be notified to the third party and registered on the account.
- (5) No official registration of a security interest with any state agency is necessary.
- (6) A pledgee may not use pledged assets as its own property.
- (7) Formal procedures apply to enforcement of a security interest.
- (8) Enforcement of a security interest may be significantly delayed by the debtor but is not stayed on insolvency.

- (9) Title transfer arrangements may be recharacterised.
- (10) Close-out netting under an ISDA Master Agreement is enforceable if one of the parties is a financial institution.
- (11) Contractual set-off is not enforceable on insolvency.
- (12) Third party claims may disrupt set-off and netting between solvent counterparties.
- (13) Top-up collateral may be avoided as a preference.

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

- (a) Yes, but only to the extent that the Fungible Securities are governed by Spanish law and represented in book-entry form and both the relevant book-entry register (which does not need to be that of the clearing system) and the clearing system is located in Spain.
- (b) Conversely, Spanish legislation does not deal clearly with the nature of the interest in a holding of Fungible Securities, where, inter alia:
 - (i) the law governing the Fungible Securities is a law other than Spanish law;
 - (ii) the Fungible Securities are cleared through a clearing system which is not located within Spain;
 - (iii) if represented in book-entry form, the relevant book-entry register for such Fungibles Securities is located outside Spain; or
 - (iv) the Fungible Securities are represented by a global note, deposited with a Central Securities Depository ("CSD").

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

In relation to Fungible Securities referred to in 1(a) above (“**Fully Spanish Securities**”), the interest of the registered holder will be characterised as an absolute interest.

As for Fungible Securities which do not fall within the scope of 1(a) above, no general response can be given. The issue should be examined on a case-by-case basis, considering, inter alia, the law governing the Fungible Securities, the contractual provisions governing each issue, the regulations of the relevant clearing-system and the law of the country where the relevant clearing system, CSD and/or book-entry registrar is located.

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

If the Fungible Securities are represented by a global bond held in immobilised form in a clearing system (“immobilised securities”), the location of the securities under Spanish law will be deemed to be the country where the global bond is deposited so that the law of the depositary will govern the perfection of a security interest, and the validity of outright transfer arrangements.

If the Fungible Securities are represented in book-entry form ("dematerialised securities"), the location of the securities under Spanish law will be deemed to be the country where the book-entry register is held.

4. Under Spain's conflict of laws rules, what law would govern:

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

With respect to the rights and obligations against the issuer of Fungible Securities, these shall be governed by the Spanish Law, to the extent that it be the express governing law of such Fungible Securities.

With respect to a person's rights in relation to the relevant clearing system and/or CSD where Fungible Securities are held, we cannot answer this in general terms, but only on a case-by-case basis.

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

With respect to cash, the law of the jurisdiction where such cash is deposited.

With respect to Fungible Securities, the law of the jurisdiction where the securities are deemed to be located, which in the case of Fungible Securities within the scope of 1(a) above is Spain.

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

As for (b) above.

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

As for (b) above.

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

(a) cash?

(b) Fungible Securities?

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 only type of security interest which can be created in either cash or Fungible Securities is a pledge.

- 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.**

Any security interest over cash or Fungible Securities deemed to be located in Spain must be created by executing a pledge agreement before a Spanish Notary or a *Corredor Colegiado de Comercio* (“Official Stockbroker”).

With respect to pledges over cash deposits, the pledge must be notified to the bank with which the deposit account is held.

With respect to pledges over securities represented in book-entry form, notice of the pledge must be served on the entity in charge of the book-entry register and it must register the pledge. The pledge will not be effective until registration is effected.

- 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.**

The pledgee is not entitled to use the collateral in any way whatsoever.

- 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.**

With respect to pledges over cash deposits, if the cash is deposited with the pledgee, then the pledgee may enforce the pledge by way of set-off. If the cash is deposited with a third party bank, enforcement of the pledge will involve requesting the bank to deliver the cash to the order of the pledgee.

With respect to pledges over Fungible Securities, Fungible Securities must be sold through an auction carried out by a Notary or an Official Stockbroker (with the procedure usually taking about two months).

The main practical difficulty is that any right of enforcement is subject to determination of the amount owed by the pledgor to the pledgee. Although the language of most pledge agreements entitles the pledgee to determine such amount unilaterally, it is very likely that if a pledgor objects to the determination made by the pledgee, the bank (in the event of pledges over cash deposits) or the Notary or Official Stockbroker (in the event of pledges over Fungible Securities) will not take the risk of either delivering the cash to the pledgee or selling the Fungible Securities by public auction, as the case may be, without having first been provided by the pledgee with a judgement stating the amount owed.

Assuming that there is a judgement obtained prior to any enforcement which states the amount owed to the pledgee by the pledgor, an insolvency official will not be entitled to seek an order for a stay or freeze in relation to the enforcement of the pledge. Pursuant to the

Spanish Commercial Code, the receivers are entitled to recover any securities pledged by the insolvent debtor only by paying the pledgee the full amount of the obligations secured by the pledge. This right may be exercised by the receivers at any time prior to the relevant securities having been sold to a third party whether in a judicial auction or in a notarial auction.

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 Spain 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.

Yes, this risk exists. In practice, this risk might be lower if the collateral arrangement is a part of a single agreement for derivative transactions and one of the parties to that single agreement is either a financial institution or an investment services company.

If the collateral arrangement is recharacterised by the relevant court, the court will find that the transferee has no proprietary interest in the collateral transferred. This means, in particular, that in the event of an insolvency of the transferor, the collateral provided should be returned to the transferor upon request of the receivers.

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?

Yes. There are two possible scenarios:

(i) Where the securities being transferred are deemed to be located in Spain, any third party creditor could challenge the validity of the collateral arrangement since, in accordance with the Spanish conflicts of laws rules, the law governing the transfer of a proprietary interest in any assets will be the law of the country where the assets are located. If the relevant securities are located in Spain any transfer of a proprietary interest in them should be governed by Spanish Law which would not recognise the effectiveness *vis-à-vis* third parties of transfer of any title collateral arrangements.

(ii) Where the securities being transferred are deemed to be located in a foreign jurisdiction whose law also governs the collateral arrangements, there is still a risk that a third party creditor could contest such arrangements on the grounds that its effects are contrary to the Spanish “public order” and by alleging that the unenforceability of transfer of title collateral arrangements is a fundamental principle of Spanish Law that cannot be avoided by a Spanish party by choosing a foreign law (even if such choice is valid pursuant to the Spanish conflicts of laws rules).

10. Is close-out netting, for example, under a 1992 ISDA Master Agreement, enforceable under the laws of Spain? 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.

Yes. Close-out netting will be enforceable provided that a single agreement covering certain types of transactions is in place and that one of the parties to that single agreement is a financial institution or an investment services company.

See also the netting opinion provided to ISDA of Clifford Chance, Madrid of September 1998.

- 11. Is contractual set-off and/or insolvency set-off enforceable in the event of formal insolvency proceedings in the courts of Spain in relation to a counterparty organised in Spain? 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 Spain 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.**

No. There are some exceptions in the jurisprudence but these will not be applicable to derivative transactions. Since contractual set-off and insolvency set-off are not enforceable in the event of formal insolvency proceedings in the courts of Spain, there is in effect a stay/freeze on any contractual set-off or insolvency set-off.

- 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?**

Pursuant to Article 1198 of the Spanish Civil Code a debtor which has not given its consent to the assignment to a third party of a debt owed by it to the assignor, will be entitled to set off the assigned obligation against any amount owing to it by the assignor prior to the date of the assignment; and to the extent the debtor is not served with notice of the assignment it will be entitled to set off the assigned obligation against any amount owing to it by the assignor prior to the date on which the debtor acquired knowledge of the assignment.

Therefore, as regards an assignment by the transferor to a third party of its right of redelivery of equivalent collateral, under Spanish law any debtor will only have the same defences against the assignee that it would have had against the assignor to the extent the debtor has not already given its consent to the assignment or does not have notice of it.

- 13. In relation to mark-to-market collateral arrangements, is there any risk under the preference (or similar) rules of Spain 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?**

Yes. This risk exists.

- 14. Please add any additional comments on the general legal framework for collateral arrangements under the laws of Spain, 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 Spain.**

The following points in particular are concerns: -

Location. Fungible securities represented by a global bond held in immobilised form will be treated as being located where the global bond is located, so that the law of the depositary will

govern the perfection of a security interest and the validity of any outright transfer arrangements.

Perfection. Security interests require notarisation in order to be perfected.

Enforcement. Enforcement of security interests over securities necessitates a procedure of at least 2 months involving notaries and a public auction. Enforcement of security interests over either securities or cash may involve a court order because of the risk that the chargor may object to the calculation of the secured obligation.

Recharacterisation. Recharacterisation risk is present in relation to title transfer arrangements.

Insolvency Set-off. Insolvency set off is generally not available.

Preferences. Preference avoidance rules may apply to deliveries of top up collateral.

The most pressing matters for law reform are the establishment of a faster procedure to determine the amount owed by the chargor or transferor, the legal recognition of collateral arrangements based on title transfer and the establishment of a maximum period for the *retroacción absoluta* (claw-back).

The Collateral Law Reform Group acknowledges the assistance of Clifford Chance, Madrid in the preparation of this report. That firm, however, accepts no liability in relation to this report.