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

Collateral Arrangements in the European Financial Markets

The Need for National Law Reform

March 2000

European Office:
International Swaps and Derivatives Association, Inc.
One New Change
London EC4M 9QQ
Telephone: +44 171 330 3550
Fax: +44 171 330 3555

Copyright © 2000 by International Swaps and Derivatives Association, Inc.

CONTENTS

Executive Summary

1. Introduction

2. Legal impediments to efficient use of collateral

3. Other issues affecting collateral arrangements

4. Review of key issues

5. Principles for law reform

6. The way forward

APPENDICES

I. *ISDA* and ISDA's Collateral Law Reform Group
II. *List of members* of Collateral Law Reform Group
III. *Glossary* of terms used in this Report and in the Country Reports

Available as separate documents:

COUNTRY REPORTS

Austria
Belgium
Denmark
Finland
France
Germany
Greece
Ireland
Italy
Luxembourg
Netherlands
Portugal
Spain
Sweden
United Kingdom (England and Wales)

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

Collateral Arrangements in the European Financial Markets

The Need for National Law Reform

EXECUTIVE SUMMARY

Taking collateral is one of the principal ways in which financial market participants reduce credit risk. Lack of legal certainty seriously impedes the efficient use of collateral and needlessly limits the amount of business that could otherwise be done on a collateralised basis. This in turn restricts access to financial services and raises costs, particularly for small- and medium-sized businesses.

Some legislative improvements have been made in recent years, for example, in Belgium, France, Luxembourg and the United Kingdom. Implementation of the Settlement Finality Directive[1] has generally brought additional clarity to one important legal issue affecting collateral arrangements, namely, which law governs the proprietary effect of the arrangement.

It remains the case, however, that current laws and rules throughout the European Union relating to the use of collateral are in many instances complex, inconsistent, impractical and/or out-of-date. They therefore create uncertainty and unpredictability regarding the effectiveness of the intended protection, leading to inefficiency, cost and increased risk for European financial markets.

In this Report, we highlight the main legal impediments to the efficient use of collateral. These are:

- cumbersome and impractical rules hampering implementation of pledge collateral arrangements
- cumbersome and impractical rules hampering enforcement of pledge collateral arrangements
- legal restrictions on the use of pledge collateral by the secured party
- uncertainty regarding the enforceability of title transfer collateral arrangements
- uncertainty under existing conflict of laws rules as to which law applies to key aspects of the collateral arrangement, including enforcement
- vulnerability of collateral arrangements to the rights of third parties
- vulnerability of "top-up" deliveries of collateral under mark-to-market collateral arrangements to avoidance under preference and similar insolvency rules

In connection with this Report, the ISDA Collateral Law Reform Group has also prepared Country Reports for the fifteen Member States of the European Union.[2] These are available separately from ISDA. The discussion of the issues above in the main text of this Report briefly summarises where the issues arise in specific European countries.

---

[1] European Directive 98/26/EC of May 19, 1998.

[2] The country report for the United Kingdom deals only with the laws of England and Wales. See first note to the United Kingdom report for further information in this regard.

This Report proposes a set of principles that an effective and efficient modern legal regime for collateral arrangements should embody. In brief, the principles are:

- rules and procedures for implementing and maintaining a collateral arrangement should be simple, clear and cost-effective
- cumbersome formalities such as registration, notification, filing and similar requirements should be abolished
- a collateral taker should be free to deal with the collateral until it is required to return it
- a giver of pledge collateral (a pledgor) should be protected from the insolvency of the taker of that collateral (the pledgee)
- the law governing the creation and priority of the collateral arrangement should be the law chosen by the parties
- where no law has been chosen by the parties, the governing law should be the law of the place where the collateral is held, collateral held through an intermediary being deemed held where the intermediary maintains the account, register or other official record representing such collateral
- the legal nature of a party's holding of securities in a clearing system should be clarified
- collateral arrangements should be protected from the rights of third parties
- "top-up" deliveries of collateral under mark-to-market collateral arrangements should be protected from avoidance under preference and similar insolvency rules

Finally, this Report makes certain suggestions as to the way forward. Appendices provide background on ISDA and the Collateral Law Reform Group, as well as a list of the Group's members and a glossary of terms that may be helpful to non-lawyers reading this Report and the related Country Reports.

1. INTRODUCTION

Europe's markets for financial services have grown enormously in recent years. This growth has brought great rewards to the European economy. The greater depth and variety of activities of market participants in the European financial markets has in turn focused the attention of participants on the need for effective management of credit risk. European and national bodies with responsibility for Europe's financial markets and securities settlement systems also have a strong interest in seeing that credit risk in these markets is effectively managed. Some of these bodies, such as the European Central Bank, the national central banks and the national government debt agencies are also themselves participants in the markets.

There are a variety of ways in which market participants may manage credit risk to reduce or eliminate it. One of the most important is the use of collateral. This is true both for transactions on organised securities and derivatives markets and for privately negotiated financial transactions such as forward foreign exchange transactions, currency options, swaps and repos. It is also true for payment systems and securities settlement systems.

A collateral arrangement, broadly defined, is an arrangement under which one party (the collateral giver) delivers some form of property, typically securities and/or cash, to another party (the collateral taker) and agrees that the collateral taker may use that property, in the

event of a default by the collateral giver, to satisfy outstanding obligations of the collateral giver to the collateral taker.

This Report and the related Country Reports have been prepared by the Collateral Law Reform Group, an *ad hoc* working group established by the International Swaps and Derivatives Association, Inc. ("ISDA") in February 1999 to study legal impediments to efficient use of collateral and to promote law reform in this regard. More information on ISDA and on the Working Group is included in Appendix I. A list of the members of the working group is included in Appendix II.

This Report has been prepared for the benefit of the European Commission, the European Central Bank and national authorities with responsibility for the legal or regulatory framework for financial activity. Although a number of lawyers have been involved in the preparation of this Report, it is intended for a broad readership, and we have attempted to keep legal jargon to a minimum. Unfortunately, however, the law relating to collateral is a particularly technical area, and, especially in preparing the Country Reports, it has not proved possible to avoid the use of technical legal terminology entirely. A glossary has been included at Appendix III, which it is hoped will be helpful to non-lawyers reviewing this Report.

2. LEGAL IMPEDIMENTS TO THE EFFICIENT USE OF COLLATERAL

Financial market participants, operating on a cross border basis, are currently faced with the following legal impediments to the efficient use of collateral:

- cumbersome and impractical rules in many jurisdictions for creating, "perfecting", maintaining and enforcing a pledge or other form of security interest in securities or cash transferred as collateral ("pledge collateral");

- legal restrictions on the use of pledge collateral by a holder of that collateral, including the possibility that any such use of the collateral endangers the security interest;

- uncertainty regarding the enforceability of title transfer based collateral arrangements ("title transfer collateral"), including the possibility of the arrangement being recharacterised as a form of security interest (that is, as pledge collateral);

- uncertainty under existing conflict of laws rules as to the substantive law that applies to a collateral arrangement for purposes of creation, perfection, maintenance and enforcement of the arrangement, including the possibility that the laws of different jurisdictions could apply for different purposes and the possibility of conflict and inconsistency amongst those jurisdictions as to which law applies;

- vulnerability of title transfer collateral arrangements to the rights of third parties, such as assignees and attaching creditors of the collateral giver;

- in the case of collateral arrangements subject to daily adjustment on a mark-to-market basis, uncertainty as to the enforceability of "top-up" deliveries of collateral due to preference and similar insolvency rules.

As indicated above, some of these difficulties are associated with pledge collateral, some with title transfer collateral, and some with both. The distinction between these alternative

approaches to establishment of a collateral arrangement is discussed in more detail below. The term "collateral", when used on its own below, encompasses both approaches.

In addition to these general difficulties, which apply to a greater or lesser extent across almost all the Member States of the European Union (and, indeed, the rest of the world), many jurisdictions have additional specific problems or uncertainties preventing the efficient use of collateral (for example, specific difficulties regarding the use of floating charges in the United Kingdom).

The combination of these general difficulties and a multiplicity of local difficulties, combined with uncertainty in many cases as to which jurisdiction's laws apply to which aspect of a collateral arrangement seriously impedes the efficient use of collateral, needlessly limiting the amount of business that could otherwise be done on a collateralised basis and restricting access to or raising the cost of financial services, particularly to small- and medium-sized businesses.

The effect of the foregoing problems is magnified for those operating cross-border by a lack of harmonisation of national rules relating to the establishment and enforcement of collateral arrangements.

In short, current laws and rules throughout the European Union relating to the use of collateral are complex, inconsistent, impractical and, in important respects, out-of-date. They therefore create uncertainty and unpredictability regarding the effectiveness of the intended protection, leading to inefficiency, cost and increased risk for Europe's financial markets.

3. OTHER ISSUES AFFECTING COLLATERAL ARRANGEMENTS

The efficiency and effectiveness of collateral arrangements are, of course, affected by factors other than the legal framework. Any work to rationalise and modernise the framework for collateral arrangements in a Member State should also take into account the impact of the regulatory framework, in particular, the regulatory capital rules, as well as the accounting and tax treatment. Consideration of these issues is beyond the scope of this Report, but any future working group looking at these issues at European or national level should not lose sight of the impact of regulatory, accounting and tax rules on collateral arrangements.

4. REVIEW OF KEY ISSUES

In this section of this Report, we consider in somewhat more detail each of the areas of legal difficulty mentioned above, referring where possible to specific Country Reports to provide concrete examples. In the following section, we set out a list of basic principles that would ideally be embodied in any proposed reform of law relating to collateral arrangements. This Report concludes with some thoughts on the way forward.

Italicised sections in this part 4 of this summary Report refer to the conclusions of the Country Reports for specific examples of the points made in the text. These conclusions are illustrative and are for general guidance only. Readers of this summary Report are referred to the individual Country Reports for more detail in relation to each country.

4.1 Cumbersome and impractical rules for creating, perfecting, maintaining and enforcing pledge collateral

Collateral arrangements in the financial markets typically involve the delivery of securities or cash by a party to another participant in the market (which may be a counterparty to a privately negotiated transaction, a clearing house for an organised market, a settlement agent for a settlement system or some other market participant with a potential credit exposure to that party) either:

- subject to a pledge or other security interest (referred to as "pledge collateral" in this paper); or
- by outright sale, as, for example, in the case of a repo transaction, or by deposit, in the case of cash collateral (referred to as "title transfer collateral" in this paper).

While arrangements involving cash collateral raise problems, greater difficulties are associated with collateral arrangements involving securities, and the remainder of this paper focuses, therefore, on these arrangements.

Of the two principal approaches to establishment of collateral, the traditional approach has been the use of pledge collateral. Under this approach the pledgor remains the owner of the assets transferred to the pledgee, the pledgee having a partial interest only. Typically, the pledgor delivers the pledge collateral to the pledgee (or its nominee), although the necessity for this varies under different national laws.

An important concern under Roman law was the possibility of a merchant extending credit to a person on the basis of his perceived wealth (that is, abundance of possessions), unaware that some or all of that wealth was, in fact, subject to encumbrances in favour of other creditors. This concern regarding “false wealth” led to the development of various rules designed to protect the merchant by giving him notice or allowing him to verify whether the goods proffered by that person as security for the extension of credit were free and clear of the claims of third parties.

These rules, often referred to by lawyers from common law jurisdictions as “perfection” requirements, take various forms in various countries, including requirements as to the form or manner of entering into (executing) the relevant pledge documentation, the making of a filing or other registration of the pledge, the use of a “pledged account” to hold the securities and/or the delivery of notice to a third party. For a variety of reasons, including uncertainty as to which rules apply (and in which cases) and the impracticality of complying with these requirements in fast-moving securities markets or in relation to dematerialised or immobilised securities held through a chain of intermediaries, these rules impede or discourage effective creation and/or perfection of valid pledge collateral arrangements.

The consequence of failure to comply with these rules, where they apply, is often the invalidity or unenforceability of the pledge collateral, a potentially disastrous result.

In relation to pledge collateral, where the collateral giver delivers the collateral to the collateral taker or its nominee, there is no policy justification for any form of registration or other notification of the pledge to any third party (or third parties generally) since the assets have passed out of the hands of the collateral giver. There are therefore no "false wealth" concerns.

Some form of registration or notification requirement may continue to make sense where the collateral giver is allowed to continue to hold the collateral, either directly or via a nominee. Any such registration or notification requirement should, however, be easy to comply with and inexpensive. It should also be possible to register or notify a single collateral arrangement once and for the duration of the arrangement (unless the terms are substantially amended during the term of the arrangement). It should not be necessary to register or notify in relation to each collateral transfer, as this would clearly be burdensome, costly and impractical given the volume of securities transfers normally entailed by modern collateral arrangements, particularly under mark-to-market collateral arrangements.

In relation to title transfer collateral, delivery of the collateral to the collateral taker or its nominee is an essential part of the creation of the arrangement, and therefore clearly no notification or registration requirement should apply.

Several European jurisdictions, namely England, France, Greece, Ireland, Netherlands, Portugal and Spain, have potentially burdensome formal requirements for the creation of a pledge or other security interest, particularly in relation to securities. These requirements are generally thought to be so burdensome as to lead financial market participants to prefer title transfer collateral, as in England, France and Ireland. In other countries, such as Spain, where title transfer collateral is itself problematic, collateralisation of financial transactions is severely hampered.

All European jurisdictions appear to require, at a minimum, notice to a third party custodian holding pledged assets that the assets are subject to a security interest. These notice requirements vary in their degree of formality and, therefore, of inconvenience. Several, however, go beyond this in certain circumstances and require either an acknowledgement by the custodian of the security interest or an annotation by the custodian on the account of the existence of the security interest, namely, Denmark, Finland, France, Italy, Luxembourg, Netherlands, Portugal and Spain. The Portuguese requirement is particularly burdensome in that each transfer of collateral appears to require a separate notification and annotation in the records of the custodian. Needless to say, acknowledgement and/or annotation requirements can be particularly burdensome in practice given the volume and frequency of securities flows involved.

4.2 Legal restrictions on use of pledge collateral

In addition to the need for reform of cumbersome formalities, most financial institutions holding collateral in the form of securities in fungible form consider it a commercial imperative that they be able to deal freely with the securities until they are required to re-deliver securities under the collateral arrangement. Freedom to deal would include the freedom to sell, lend or repo the securities or to re-pledge (rehypothecate) them to a third party, subject always to an obligation to return equivalent fungible securities to the collateral provider assuming that it performs its obligations in full. By dealing freely with the securities, the financial institution holding the collateral is able to use it most efficiently, lowering its own costs and therefore the cost of financial services provided to the collateral provider.

Under pledge collateral arrangements, however, the pledgee has only a partial interest in the pledge collateral it holds, and therefore any use of the collateral (except possibly re-pledging of the collateral) risks destroying the original security interest by disposing of the ownership interest of the pledgor out of which the limited interest of the pledgee arose.

In addition, a pledgee generally has fiduciary obligations in relation to the custody of collateral that are unnecessary in the context of tradable dematerialised or immobilised securities.

In all European jurisdictions other than England, Greece and Ireland, it is not possible for a pledgee to use the pledged assets as though it were the absolute owner of those assets.

In Italy, although it is not possible under a traditional pledge for a pledgee to use the pledged assets, it may do so under an irregular pledge. There is some academic discussion in Germany whether there is a similar possibility of creating an irregular pledge in this sense. The position in Germany is, however, subject to debate. In either case, an irregular pledge does not appear to be a security interest in the normal sense (that is, a form of proprietary interest by way of security), but seems instead to be in substance a form of transfer of title, albeit for a limited purpose.

In England and Ireland, use of the pledged (charged) assets by the pledgee (chargee) may be permitted by the underlying contract, but it remains unclear whether this is consistent with the nature of a security interest and therefore what the effect of such use is.

4.3 Uncertainty regarding enforceability of title transfer collateral

Title transfer collateral was developed in order to avoid the difficulties associated with cumbersome rules for creation/perfection and restrictions on the use of pledge collateral. Because the transferee of title transfer collateral in the form of securities is the legal owner of those securities, it is entitled to do what it likes with them, subject only to a contractual obligation to return equivalent fungible securities. Because it is the owner, it is also free of fiduciary obligations to the transferor in relation to the custody of the collateral.

It is important to note also, however, that the transferor has a mere contractual claim against the transferee in relation to title transfer collateral, and therefore would be an unsecured creditor for the value of the collateral in the event of the transferee's insolvency. Under a pledge, a pledgee only has a partial interest in pledge collateral. Thus, the pledgor is generally able to redeem the collateral out of the estate of an insolvent pledgee on the basis of its continuing proprietary interest, and the collateral is therefore not available to creditors of the pledgee.

While title transfer collateral (of which securities lending and repo arrangements are special cases) works well as a practical matter in relation to modern methods of trading, holding and transferring securities, in some jurisdictions there is thought to be a significant risk that it would be recharacterised as pledge collateral because its purpose is similar to the purpose of pledge collateral.

Recharacterisation would, of course, defeat the purpose of using a title transfer collateral arrangement to avoid cumbersome formalities and restrictions on use. Generally speaking, the recharacterised arrangement would not satisfy the necessary formalities and restrictions, and therefore could be void, vulnerable to avoidance or otherwise unenforceable.

In many jurisdictions, *including England*, recharacterisation risk is avoided on the basis that, notwithstanding the purpose of the arrangement being essentially the same as a pledge, the credit risk taken by the transferor on the transferee means that there is a substantive difference between pledge collateral and title transfer collateral. On that basis, therefore, the

choice of the title transfer approach is not a sham, but a genuine and legitimate choice, with its own set of advantages and, of course, risks.

Other jurisdictions lay more emphasis on the intended purpose and would therefore recharacterise (presumably for policy reasons) notwithstanding the substantive difference between the approaches. In addition, since title transfer collateral arrangements are based ultimately on set-off or netting, they are vulnerable if there are restrictions on insolvency set-off in the collateral provider's home jurisdiction or if the relevant netting legislation in that jurisdiction is not broad enough to encompass title transfer collateral.

Jurisdictions where there appears to be significant risk of recharacterisation of a title transfer collateral arrangements are Denmark, Finland, Greece, Italy, Netherlands and Spain. It is also not clear to what extent such arrangements may be recharacterised in Luxembourg.

In Italy, however, a title transfer arrangement would normally be recharacterised as an irregular pledge (pegno irregolare), which has the effect in substance of transferring title to the pledgee. In Austria and Germany title transfer arrangements will not be recharacterised but certain provisions might mandatorily apply as they would for a security interest. Certain mandatory obligations will also apply in Luxembourg.

Of the above jurisdictions, Spain also prohibits insolvency set-off, so a title transfer based arrangement would not work even if it were not recharacterised. In Portugal, insolvency set-off is also prohibited, but the collateral taker under a title transfer arrangement may exercise its right of set-off at any time after the proceedings commence but prior to the bankruptcy order being made. In practice, this should protect the collateral taker from the effect of the post-bankruptcy order prohibition on set-off.

4.4 Uncertainty as to conflict of laws rules

One of the most difficult areas for global financial institutions operating on a cross border basis is determining which jurisdiction's laws apply to which aspect of a collateral arrangement, including creation/perfection, priority relative to adverse claimants and enforceability of the arrangement. Not only are the choice of law rules potentially difficult to apply within a single jurisdiction, but another jurisdiction relative to the arrangement might choose differently, meaning that the same question (for example, whose law governs perfection in a particular case?) will be answered differently by courts in different jurisdictions.

These rules, to the extent they apply to securities, are generally based on the assumption that the security exists in certificated form in the hands of the collateral giver. They deal inadequately and with paradoxical results in relation to securities held in dematerialised or immobilised form in modern clearing systems and/or through a chain of intermediaries.

While article 9(2) of the recently adopted Settlement Finality Directive is a helpful provision in this regard, its effect is limited.

The issues raised by the application of conflict of laws rules to securities in dematerialised or immobilised form are extensively and expertly discussed in a discussion paper by Randall Guynn entitled "Modernizing Securities Ownership, Transfer and Pledging Laws", published, together with brief commentaries by other experts, by the International Bar Association in February 1996.

While the implementation of article 9(2) helps clarify the question of the location of pledged assets for purposes of conflict of laws rules, the legal nature of a clearing system participant's interest in dematerialised or immobilised securities continues to be unclear in a number of European jurisdictions. The position is relatively clear in Austria, Belgium, France, Italy and Luxembourg, which have dealt with these issues by statute, and in Finland and Greece where the position appears to be clear as a matter of general law. In the Netherlands, Spain and Sweden, the position appears to be clear as a matter of statute in relation to securities held in certain domestic clearing systems, but not otherwise.

4.5 Vulnerability of title transfer collateral arrangements to the rights of third parties

In virtually all jurisdictions, on insolvency, set-off is restricted to mutual debts owed between the insolvent and its creditor. Generally speaking, the same mutuality requirement applies to netting of claims owed between the insolvent and the creditor. In the context of a title transfer collateral arrangement, this means that the collateral giver must be personally liable in relation to the debt(s) supported by the title transfer arrangement and fully entitled, subject to the terms of the arrangement, to the value of the collateral given under the arrangement.

If a third party is able to claim the collateral back from the collateral taker in priority to the collateral giver, then the mutuality requirement has been disrupted and the set-off or netting on which the arrangement is based will likely fail. Typical third parties which might be capable of disrupting the mutuality in this way would include a third party to whom the collateral giver had assigned its right to return of the collateral or a third party creditor seeking to attach the collateral giver's contractual right to return of the collateral in satisfaction of the debt owed to it. This sort of disruption might occur through default or negligence by the collateral giver or simply by operation of law.

The main jurisdiction where this risk is thought to arise include is Spain, although there is thought to be some risk, or at least uncertainty, on this point in Finland, France, Germany, Greece, Italy and Portugal.

4.6 Vulnerability of mark-to-market collateral arrangements

Collateral arrangements intended to secure or support net credit exposure under a master agreement are generally adjusted on a daily basis (sometimes less frequently) by comparing the net exposure under the master agreement with the value of collateral on hand. If there is a shortfall of collateral, additional or "top-up" collateral must be provided. If there is a surplus of collateral, then some or all of the surplus may be returned to the collateral provider. Margining arrangements in relation to futures and options on organised markets generally operate on a similar basis and many jurisdictions have introduced specific legislation to confirm the enforceability of such arrangements.

Under the preference rules of some jurisdictions, deliveries of top-up collateral made by a party during a specified period (the "suspect" or "preference" period) prior to its insolvency may be invalidated by the liquidator or other relevant insolvency official, requiring the collateral holder to return the "top-up" collateral without deduction, off-set or other application against the exposure of the collateral holder to the insolvent.

In addition, under "zero hour" rules of some jurisdictions, formal insolvency proceedings are deemed to commence at the midnight immediately preceding the time that the formal

insolvency proceedings were actually initiated (for example, by petition of a creditor or by court order). This can mean that transfers of collateral occurring prior to the time proceedings were actually initiated could also be subject to avoidance by the liquidator or other relevant insolvency official.

When daily collateral movements have occurred over the course of, say, a six-month suspect period, a substantial portion of the collateral held by the collateral holder could be subject to avoidance in this way, with potentially grave consequences for the collateral holder (and possibly, by consequence, for its creditors).

Mark-to-market collateral arrangements created during a suspect period should continue to be subject to preference and similar insolvency rules in the same way that other collateral arrangements would be subject to those rules. It should not be the case, however, that a "top-up" delivery of collateral is void or vulnerable to avoidance *merely* because it occurs during the suspect period in circumstances where the collateral arrangement itself is otherwise not vulnerable under such rules.

There is a material risk that top-up collateral deliveries may be vulnerable as a preference during the relevant suspect period in each of Denmark, France, Greece, Italy and Spain.

5. PRINCIPLES FOR LAW REFORM

It is acknowledged that any proposal to rationalise and harmonise national laws in each of the Member States with regard to collateral arrangements is necessarily ambitious. While the Settlement Finality Directive was a valuable step in that direction, its aims were, and therefore its effect when implemented in each Member State will be, necessarily limited.

Fundamental issues of property law and insolvency law, as well as a number of other relevant areas of law, will need to be addressed from both a civil law and a common law perspective, and even within those traditions from perspectives that will vary across the Member States in accordance with their political, cultural and social background and approach to these issues. As noted above, existing financial regulation, accounting standards and tax treatment will also need to be considered.

Nonetheless, the challenge facing Europe in this regard is simply part of the greater on-going challenge of creating first an economic community and then a single market and currency union.

There are some basic principles that should underlie any proposed reform of the law relating to collateral arrangements involving cash and securities. The ideal regime would combine the best elements of the pledge collateral and title transfer collateral approaches, perhaps obviating the need for these alternatives. It is suggested that this can be achieved, while safeguarding the interests of the collateral taker, the collateral provider and third party creditors of each of these parties, by establishment of a regime embodying the following principles:

- Apart from entry into a straightforward written contract outlining the terms of the collateral arrangement, no special procedures for establishing the collateral arrangement should be necessary.

- Therefore, there should be no (or very minimal) requirements regarding the form, content and/or manner of entering into the document, the essential requirement being

that it be clear as to its terms, the scope of the obligations secured and the nature of the collateral covered.

- There should be no requirement that any registration or filing be made with any authority or any notice given to any third party, except in relation to pledge collateral in circumstances where the collateral giver (the pledgor) is allowed to remain in possession of the collateral. Where such a requirement does apply, it should apply once only for the whole arrangement and not in relation to each collateral transfer. It should also be easy to comply with and inexpensive.

- The collateral taker should be free to deal with the collateral as though it were the outright owner of the assets, and third parties purchasing from the collateral taker should be able to obtain a clean title to the assets, whether or not they have notice of the original interest of the collateral provider.

- In the event of the insolvency of a taker of pledge collateral (a pledgee), the collateral provider (the pledgor) should be able to redeem its securities from the estate of the pledgee.

- Where no law has been chosen by the parties, the law governing the rights of parties to collateral held through an intermediary should be the law of the jurisdiction where the intermediary maintains the account, register or other official record representing such collateral.

- For any purpose for which it is relevant, the law should make clear that the interest of a party in dematerialised or immobilised securities held by a financial intermediary in a clearing system consists of a personal and co-proprietary interest in a pro rata portion of the pool of securities held by that financial intermediary in that clearing system, and not as a traceable property right in individual securities held by a sub-custodian or as a mere contractual claim against that financial intermediary.

- Title transfer collateral arrangements should be protected from action by a third party, such as an assignee or attaching creditor, seeking to take the collateral in priority to the collateral taker.

- Mark-to-market collateral arrangements should be protected from the effect of preference and zero-hour rules (and similar insolvency rules) provided that they were entered into, in the case of preference rules, prior to commencement of the relevant suspect period (or would not otherwise be subject to the preference or similar rule if entered into during that period).

6. THE WAY FORWARD

Given the complexity and fundamental diversity of national laws dealing with creditors' rights, property, contract and insolvency, the Collateral Law Reform Group commends the decision of the Commission to convene its Forum Group on Collateral to consider these issues in the context of the Commission's implementation of its Financial Services Action Plan.

There are a number of professional bodies and industry associations across Europe and in other parts of the world that have produced valuable work on these issues (a notable example being the IBA paper referred to above) and which continue to study them. The

Commission's Forum Group has plenty of source material and considerable expertise within the industry to call upon in this endeavour.

It is assumed that the Forum Group will be asked to aid the Commission in focusing and clarifying the issues, and that the Commission will then conduct a wider consultation with the market on these issues and possible solutions. Finally, after the consultation, the Forum Group could be of considerable assistance to the Commission in formulating recommendations to individual Member States regarding the steps necessary to reform their laws to ensure an efficient and effective legal regime for collateral arrangements.

The history of the European Bankruptcy Convention, and similar efforts in the past, shows the difficulty of attempting rationalisation or harmonisation in any area significantly affecting insolvency law. On the other hand, the considerable convergence of netting laws across the European Union, which of necessity affect the application of national insolvency law, shows there is room for optimism.

A clear, practical and robust legal regime for collateral in each Member State, as well as a high degree of practical harmonisation across Europe, will be of immeasurable value in strengthening European financial markets, reducing credit risk for individual market participants, the organised markets, and clearing, payment and settlement systems, and minimising systemic risk. If there is a sufficient degree of practical harmonisation, this should promote integration and deeper, more liquid and more competitive European financial markets.

Appendix I

ISDA® AND ISDA's COLLATERAL LAW REFORM GROUP

The International Swaps and Derivatives Association, Inc. (ISDA) is the leading global trade association representing professional-market participants in privately negotiated derivative transactions. Privately negotiated derivative transactions include interest rate, currency, equity, commodity and credit swaps, options and forward transactions, as well as such related products as forward rate agreements (FRAs), caps, collars, floors and swaptions.

ISDA, chartered in 1985, today numbers approximately 450 members from 34 countries around the world, of whom more than half are established in Europe. Of those established outside Europe, many, if not most, have significant operations in the European markets. ISDA's members include most of the world's major financial institutions as well as leading end-users of privately negotiated derivatives and suppliers and consultants to the industry, including law firms, accountants and information technology companies.

ISDA's members have been using collateral to reduce credit risk in relation to privately negotiated derivatives transactions for a number of years, during the course of which, through working groups composed of member experts, ISDA:

- drafted and published forms of collateral documentation (Credit Support Annex or Credit Support Deed) under English, New York and Japanese law, together with User's Guides to those documents;

- has commissioned and distributed to its members legal opinions from a number of jurisdictions on the enforceability of those documents and continues to seek opinions from additional jurisdictions;

- prepared and published its original Guidelines for Collateral Practitioners in November 1998 and an updated overview of issues relating to collateral management, the ISDA 1999 Collateral Review, in March 1999;

- continues to study collateral management with a view to improving standards and efficiency in the market: including reviews of market standard documentation, with a view to updating, clarifying and streamlining the documentation to enhance its usability cross border.

As part of the above process, ISDA's members some time ago identified legal risk as a crucial issue for establishing effective and efficient collateral arrangements. This issue was highlighted in ISDA's March 1998 paper Credit Risk and Regulatory Capital, as well as in the Guidelines for Collateral Practitioners and 1999 Collateral Review mentioned above.

In the context of the European Commission's review last year of its strategy for financial services, ISDA urged the Internal Market Directorate General to include action to promote reform of national laws relating to collateral in its final plan. It did so, and indeed collateral law reform forms one of the five core objectives of the Commission's plan.

To assist the Commission in this work, ISDA formed its Collateral Law Reform Group earlier this year. This working group, the members of which are listed in Appendix II, has prepared this Report, and the related Country Reports, with a view to contributing to financial market discussions on

collateral law reform. Drafts of this Report and the Country Reports were circulated widely within the membership of ISDA, and the final versions of this Report and the Country Reports reflect comments received during this consultation.

This Report and the Country Reports are offered as a contribution to European discussions of these issues, in the hope that it will help to clarify and focus the many important issues that need to be addressed at national level across the EU in order to develop an efficient, coherent and modernised legal framework for collateral in each EU Member State, as well as a sensible degree of practical harmonisation for cross border collateral arrangements.

Appendix II

LIST OF COLLATERAL LAW REFORM GROUP MEMBERS

Name	**Institution**
Edward Murray, *Chairman*	Allen & Overy, Paris
Joanna Benjamin	Clifford Chance, London
Nick Collier	International Swaps and Derivatives Association, Inc., London
Fabrizio Colonna	Unicredito Italiano, Milan
Luigi de Ghenghi	Euroclear, Brussels
Pierre Gissinger	Allen & Overy, Paris
Randall Guynn	Davis, Polk & Wardwell, London
Hendrik Haag	Hengeler Müller Weitzel Wirtz, Frankfurt
Susan Hall	Royal Bank of Scotland, London
Mark Harding	UBS Warburg Dillon Read, London (*Chairman of ISDA*)
Holger Hartenfels	Commerzbank, Frankfurt
Robert McWilliam	ABN AMRO Bank N.V., London
Richard Metcalfe	International Swaps and Derivatives Association, Inc., London
Guy Morton	Freshfields, London
Habib Motani	Clifford Chance, London
Richard Potok	Potok & Co, London
Christopher Whiteley	Allen & Overy, Paris

Appendix III

GLOSSARY OF TERMS USED IN THIS REPORT AND IN THE COUNTRY REPORTS

Term	Definition
absolute title, legal title	the right to possess and use/enjoy property; absolute title is not qualified but legal title may be qualified by the rights of third parties with an interest in the property
acceleration, early termination, automatic early termination	the declaration (usually as a result of an express right in a contract) that a previously contingent obligation is due and payable following specified events; early termination applies where both parties have obligations to each other and those obligations are accelerated and their value set off, this may be automatic on the occurrence of one or more specified events
after-acquired property, future property	future property is the expectancy that assets or rights may be acquired; after-acquired property may include additional rights subsequently acquired with respect to assets or rights in which an interest is already held
beneficial interest, fiduciary	a form of divided ownership in which legal title or possession of property may be held by one person, as fiduciary, and the right to use/enjoy the property belongs to a third party
book-entry, omnibus account, segregated account	the representation of property rights as entries in a register whether those rights are to a share in a pool of assets held in an omnibus account, or a right to assets held separately (and separately identifiable) in a segregated account
charge, charge-back, chargee, chargor	a form of security interest granted by a chargor over its property to a chargee; where the property concerned is a claim of the chargor against the chargee (such as a right of a depositor to be repaid his deposit by the bank) this is called a charge-back
cherry-picking	the adoption of profitable contracts by a liquidator and the repudiation of unprofitable contracts (requiring the counterparty to sue for damages at the insolvency dividend rate): cherry-picking produces the opposite commercial result to set-off
close-out netting, First Method, Second Method	the process by which outstanding transactions are terminated as of a particular date and a net payment becomes due based on their aggregate values; the First Method is an election under the 1992 ISDA Master Agreement which requires values to be netted but no payment becomes due to the party which has breached the agreement triggering early termination; the Second Method requires a net payment to be made to the relevant party even if that party is the party in breach
collateral, credit support	the generic term for property provided by one party to the other to mitigate the transferee's credit risk on the transferor; the term collateral derives from "collateral security" as opposed to the principal security, which in the old days would typically have been land and buildings - as a result it is more of a commercial term than a legal one and can be used to refer to security interest or title transfer arrangements; credit support is the term used in ISDA documentation for all forms of credit risk mitigation techniques
conflicts of law, Rome Convention	the principles governing the rights of civil and commercial persons where these may be creatures of, or also subject to, a foreign legal system or international law; these are codified in relation to contracts in the Rome Convention on the Law Applicable to Contractual Obligations 1980 which applies in EU Member States

connexity	the degree of inter-relationship between different obligations which is a requirement for certain forms of set-off on insolvency
constructive possession	possession by a third party, such as a custodian or bailee, without a claim to any interest in the property on behalf of those persons who do have a claim
conveyance, transfer in trust, traceable	a conveyance is a transfer of absolute title to property; a transfer in trust is a transfer of the legal title to the fiduciary while the beneficial interest remains with a third party; the person with a beneficial interest may defeat a conveyance in breach of his beneficial interest if the property is traceable: this will prevent the recipient from acquiring absolute title
Central Securities Depository ("CSD")	a custodian acting as a central depository whose account-holders are typically financial institutions which in turn hold rights to fungible securities in pooled or segregated accounts on behalf of their customers or for their own proprietary account
custodian, intermediary	a third party appointed to safe-keep assets on behalf of account-holders whose rights to those assets will be shown by entries in a register or similar set of records (typically in computerised form)
distrain, execution, summons	these are court procedures; distrain and execution refer to steps taken to enforce judgements; summons is a step taken to initiate proceedings in certain types of court
encumbrance, security interest	interests in property which qualify the general rights of the owner to use and enjoy the property; a security interest is a form of encumbrance which allows the secured party to apply the property to discharge specified obligations and which usually requires the owner of the property to preserve the property so that it is available for this purpose
enforcement, foreclosure	the process by which a secured party seizes property subject to the security interest and applies it to discharge the secured obligations: the secured party may realise the value of the property by selling it, or may foreclose on the property by appropriating it as its own
equity	in common law jurisdictions equitable principles are a source of law; in other jurisdictions the term equity has no technical meaning, but equates to principles of natural justice
fungible assets, negotiable, specific assets	assets of the same quality and amount which are interchangeable with each other; in relation to claims against third parties such as those represented by securities this requires that the claims are negotiable, that is that they can be transferred/assigned; specific assets are those which are separately identified, such as securities identified by a certificate number
immobilised securities, dematerialised securities	securities are immobilised if held in certificated form (including as a global note) in a clearing system; dematerialised securities are not represented by any physical certificate but only a central register maintained by the issuer or its agent (such as UK gilts)
in rem, in personam, personal right	a right *in rem* is a property right, being an interest in specified assets; a personal right or a right *in personam* is a right against a third party: this may be a receivable, or may be a right to require a third party to act in a particular way, for example to require a trustee to act in accordance with the terms of the trust
intervener	a third party (such as an attaching creditor) who asserts rights to property such as an obligation due to a party in default, thereby preventing set-off by the non-defaulting party where this requires that the obligations to be set off are mutual

Term	Definition
lex cartae sitae, lex rei sitae, lex situs, lex loci	the law of the jurisdiction in which property is located; in the case of lex cartae sitae and the lex rei sitae the property must be tangible; in the case of lex situs and lex loci the property may be an intangible
lien, right of retention	a defence to any action for the return of property to the true owner as a result of the outstanding obligations of the owner
Loss, Market Quotation	Loss and Market Quotation are alternative elections under the ISDA Master Agreement used to determine how transactions terminated early should be valued for the purposes of close-out netting
margin, security assets	property subject to a security interest provided by one party to the other to mitigate the transferee's credit risk on the transferor; margin usually refers to security assets where the secured exposure results from trading on an exchange or in foreign currencies
mark-to-market, top-up collateral	the process of valuing an exposure (arising from future obligations) based on current market prices; top-up collateral is additional collateral provided by one party to the other as a result of changes in the mark-to-market value of the exposure and/or the collateral
mortgage, mortgagee, mortgagor	a form of security interest granted by a party (the mortgagor) over its property to another party (the mortgagee) together with a transfer of the property to the mortgagee or a promise to transfer
moveable, receivable	a moveable is physical (tangible) property other than land; a receivable is intangible property, being a claim against a third party for performance of some obligation owed to the claimant
notarisation	formal endorsement by a notary as a court-appointed official to confirm authenticity and legal effect
official registration	registration with a government entity
paulian action, preference, suspect period, look-back period, claw-back period	paulian action is the roman law equivalent of preference; both terms refer to collusion between a debtor and its creditor so that or with the intention that such creditor is repaid in advance of other creditors: any transaction (including the giving of security) that does this will be set aside if the debtor becomes insolvent within a specified time-frame which is usually referred to as the suspect period, look-back period or claw-back period; this period will usually be longer if the debtor and creditor are connected in some way (for example, if they are part of the same group of companies)
perfection, priority, publication	the purpose of a security interest is to give the secured party's claims priority over those of other creditors and to make specific assets available to satisfy it; the process by which assets are allocated to meet the secured party's claim is usually referred to as perfection or publication, since the purpose of this is to put other creditors on notice of the security interest and to prevent the assets being alienated from the debtor's estate
pledge, pledgee, pledgor	a form of security interest granted by a party (the pledgor) over its property to another party (the pledgee)
power of attorney	an act delegating to one person the power to act (in a general or limited way) on the other person's behalf
promissory note	a debt obligation to pay a specified amount, or an amount based on a specified formula on a specified date and evidenced by a certificate
recharacterisation	the refusal of a court to recognise the legal characterisation of a transaction given it by the parties, and the imposition of requirements or implication of terms based on a different characterisation

recognised market, stock exchange	a stock exchange provides facilities for trading securities (equity or debt) issued by third parties which are listed on it; a market may also provide facilities for the trading of contracts whose terms are set by the market itself (as with a derivatives or commodities exchange); EU law requires the mutual recognition of markets in different Member States and regulatory authorities may also recognise markets in other jurisdictions
rehypothecation	in its narrow sense this means the use of pledged assets by the pledgee to give as security for the pledgee's own obligations and this will be subject to the original pledgor's rights to return of the property; however it is also sometimes loosely used in a broader sense to mean use of pledged assets by the pledgee as if it owned those assets, for example, sale of the pledged assets by the pledgee to a third party
reorganisation, rehabilitation, administration, composition proceedings, debt recomposition proceedings, examination, receivership, restructuring, voluntary arrangement	insolvency proceedings whose objective is generally the preservation of the insolvent as a going concern or, at any rate, enhanced protection of the insolvent for a period of time to permit a more advantageous realisation of the assets of the insolvent than under an immediate liquidation
repo, securities repurchase, securities lending	a transaction where one party sells securities to the other at the outset and the parties agree the other will sell securities of the same type at the same price back to the other party at a specified date in the future; where the party selling the securities at the outset chooses which securities these should be the transaction is a repo or securities repurchase transaction and has the commercial effect of a secured loan; where the party buying the securities at the outset chooses which securities these should be the transaction is a securities lending transaction and allows the buyer to cover a short position in those securities
secured exposure, secured liability, secured obligation	the obligation agreed by the parties in discharge of which the security assets can be applied; usually this will also be used to determine the value of the property given as security, however in some circumstances a different measure of exposure may be used
set-off, contractual set-off, netting	the discharge of opposite obligations to the extent of the smaller obligation; a right of set-off may exist generally at law or by agreement between the parties (contractual set-off); netting has the same commercial result but this may be achieved in different ways
stay, freeze	the suspension of a creditor's right to enforce security or foreclose as a result of the debtor being insolvent; the suspension may only last for a specified period (for example during any corporate rehabilitation proceedings) or may be permanent
title transfer	a form of collateral arrangement where absolute title to the underlying assets is transferred in exchange for a promise to return equivalent (fungible) assets subject to a right of set-off;