



COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMUNICATION FROM THE COMMISSION
TO THE EUROPEAN PARLIAMENT

pursuant to the second subparagraph of Article 189 b (2) of the EC-Treaty

**ON THE COMMON POSITION ADOPTED BY THE COUNCIL ON 13 OCTOBER 1997
WITH A VIEW TO ADOPTING DIRECTIVE 97/ /EC
OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL
ON SETTLEMENT FINALITY IN PAYMENT AND SECURITIES SETTLEMENT SYSTEMS**

1. BACKGROUND

1. On 30 May 1996, the Commission adopted a proposal for a Directive on Settlement Finality and Collateral Security¹. This text was forwarded to the Parliament, the Council, the Economic and Social Committee and the European Monetary Institute.
2. The Council began to examine the proposal on 20 September 1996.
3. The Economic and Social Committee unanimously adopted an opinion on the Commission proposal on 31 October 1996, in which it recommended that securities settlement systems be included in the scope of the proposal².
4. The European Monetary Institute delivered its opinion on 21 November 1996. It welcomed the proposal and stressed its crucial importance to the efficient and smooth functioning of payment systems; it also recommended that securities settlement systems should be included in the scope.
5. The European Parliament welcomed this proposal and adopted its opinion on the Commission proposal during its plenary meeting of 9 April 1997³.
6. On 4 July 1997, the Commission adopted its amended proposal⁴ in the light of the consultation of the European Parliament, the Economic and Social Committee and the European Monetary Institute.
7. On 13 October 1997, the Council adopted the common position which is the subject of this communication.

¹ COM (96) 193 final, OJ N° C 207, 18.07.1996., p. 13.

² OJ N° C 56, 24.02.97., p. 1.

³ not yet published

⁴ Amended proposal for a European Parliament and Council Directive on settlement finality and collateral security (to be renamed 'On the limitation of systemic risk in payment and securities settlement systems'), COM/97/0345 final - COD 96/0126, Official journal NO. C 259 , 26/08/1997 p. 6.

2. PURPOSE OF THE COMMISSION PROPOSAL

- The principal objective is to reduce systemic risk in payment and securities settlement systems. Systemic risk is the risk that the illiquidity or failure of one participant in a system and its resulting inability to pay up its own obligations when due, will lead to liquidity problems -or worse- for other participants and will have further knock-on effects on financial markets at large. To this end the Directive stipulates that netting shall be legally enforceable, that transfer orders shall not be revoked once they have entered into a payment or a securities settlement system, that insolvency proceedings shall not be applied retroactively and that the applicable insolvency law is the law of the Member State of the system.
- Under the proposal, the rights of the system to the collateral security are insulated from the effects of the insolvency proceedings against a participant. It should be noted that also collateral provided to Member State Central Banks or to the future European Central Bank falls under the proposal's scope.
- This Directive furthermore contributes to enhancing the cost efficiency of payment and securities settlement systems
- Finally, it provides a legal framework for the payment flows between Member States, and thus contributes to the smooth functioning of the single monetary policy within the Economic and Monetary Union.

3. COMMENTS ON THE COMMON POSITION

3.1. GENERAL CONSIDERATIONS

In their opinions, the European Monetary Institute, the Economic and Social Committee and the European Parliament advised to include securities settlement systems in the scope of this Directive. This suggestion has been followed by the Council in its common position.

In its opinion, the European Parliament furthermore insisted on a provision determining the moment in time when an insolvency proceeding can be deemed to be opened for the purposes of this Directive. It also requested a notification procedure, whereby the relevant authorities would be informed of the insolvency of a system participant. The Council common position reflects these concerns.

3.2. THE EUROPEAN PARLIAMENT'S AMENDMENTS IN FIRST READING

Parliament voted 21 amendments to the Commission's initial proposal. The Commission accepted 11 of these amendments literally and accepted a further 4 amendments subject to minor modifications. A large number of Parliament's amendments have been incorporated in spirit in the common position, albeit not literally.

Title of the proposed directive

Building on the title proposed by the Parliament (amendment 1 of Parliament: "Proposal for a European Parliament and Council Directive on the treatment of payment systems and securities settlement systems in the context of insolvency proceedings concerning credit or securities institutions), and on the title retained by the Commission in its amended proposal ("Proposal for a European Parliament and Council Directive on the limitation of systemic risk in payment and securities settlement systems"), the Council proposed as a title "Directive of the European Parliament and the Council on Settlement Finality in payment and securities settlement systems".

Recitals

Recital 1 of the modified proposal (amendment 2 of Parliament) has in essence been taken over in the Council's common position, in changing the order of the recitals in such a way that recital 1 has become recital 5 in the Council's common position. The reference to the harmonisation of the laws on bankruptcy of credit and securities institutions has not been retained in the Council common position, since all European initiatives in that field have been based on the principle of mutual recognition by the Member States of each other's insolvency law, rather than on the principle of harmonisation.

Recital 7a in the modified proposal (amendment 3 of Parliament) needed not be retained in the Council common position given that this already appears in recital 1.

A number of new recitals have been introduced in the common position so as to clarify in greater detail the various provisions of the Directive. These recitals are acceptable to the Commission.

Articles of the directive

In Article 1 (1) of the modified proposal (amendment 4 of Parliament) the Commission found that the terms "and the Euro" should not be used besides "Ecu", since Euro and Ecu will not coexist. When the Euro is introduced, references in legal instruments to the ECU will automatically be replaced by references to Euro. In its common position, the Council followed this view. It takes over Article 1 (1) of the amended proposal, even though no separate mention is made of payment systems and securities settlement systems. Instead, reference is made to "system" which is defined in Article 2. Also, the mention of collateral security has been given a separate indent for the sake of greater clarity.

Article 1 (2) of the modified proposal (amendment 5 of Parliament) has not been carried over to the Council's common position. Although the Community would not exceed its legislative competences in regulating community institutions which participate in third country systems, the Council preferred not to include this situation. Member States may nevertheless choose to apply the Directive to their domestic institutions participating in third country systems, as specified in recital 7. It is clear, on the other hand, that third country institutions which participate in Community systems are, of course, covered.

The idea, contained in Amendment 6 of the European Parliament's opinion, of giving publicity to the existence and membership of a system, has been incorporated in the Council's common position in article 10, be it in a slightly amended form.

Article 2a of the amended proposal (amendment 7 of Parliament), which defines the concept of "institution", has been taken over in article 2b of the Council common position, but includes also investment firms, which are the typical participants in a securities settlement system. The Council common position adds two other categories of institution, namely public authorities and publicly guaranteed undertakings and any undertaking whose head office is outside the Community and whose functions correspond to those of Community credit institutions or investment firms. These additions are made to restrict the definition of institution to these four categories (credit institutions, investment firms, public authorities and publicly guaranteed undertakings and undertakings with head office outside the Community with corresponding function), contrary to the amended proposal, where the definition of "institution" included "any undertaking which participates directly in a payment or securities settlement system".

Article 2b of the amended proposal (amendment 8 of Parliament), which defines "direct" participation in a payment of a securities settlement system, is not retained in the Council's common position. This is because -contrary to the original Commission proposal as well as to the amended proposal- the scope of the common position is no longer restricted to direct participants only, but provides in article 2f and g for the possibility for Member States to include an indirect participant if such participant is a credit institution and if its inclusion is warranted on the grounds of systemic risk. In the further text, the reference to "direct participation" in wording such as "any institution which participates *directly* in a payment or securities settlement system" is systematically deleted.

Article 2e of the amended proposal (amendment 9 of Parliament) relating to the definition of "payment order", has been changed in the Council common position. The concept to be defined itself has changed form "payment order" to "transfer order" (article 2i), so as to include orders for a securities transfer.

Article 2h and 2 la of the amended proposal (amendment 10 and 15 of Parliament), which define respectively payment and securities settlement systems, have been redrafted in the Council common position. The Council common position in its article 2a defines the concept of "system", which englobes payment and securities settlement systems and any combination of both. This definition is also more detailed and more restrictive than the definitions of "payment system" and of "securities settlement system" in the amended proposal. In the further text of the proposal, the separate mentioning of "payment systems" and "securities settlement systems" is systematically replaced by the word "system".

Article 2i and article 2j of the amended proposal (amendment 11 and 12 of Parliament) have been deleted, as they have become superfluous. Indeed, the Council has chosen to exclude from the scope of this Directive the reference to community institutions which participate in third country systems (in Article 1 (2) of the amended proposal as well as of the original proposal).

The common position refers to operations of the central banks of the Member States in their functions as central banks, instead of referring to "monetary policy operations". Therefore, Article 2k of the amended proposal (amendment 13 of Parliament), which defines "monetary policy operations", has also become superfluous.

Article 2 l of the amended proposal (amendment 14 of Parliament), which defines "collateral security", has been taken over with a few adjustments in the Council's common position, where it has become article 2m. In essence, the modifications mean that the definition now refers to "realisable" assets and that it enumerates examples of ways to provide collateral security (pledge agreement, repurchase agreement) in a non-exhaustive manner.

Article 3 (1) of the amended proposal (amendment 16 (1) of Parliament), has been retained in the Council common position, with a few modifications and additions. As announced above, the scope of the common position is no longer restricted to direct participants only, but provides for the possibility for Member States to include an indirect participant. The wording of this article has been changed accordingly in the common position from "institution which participates directly in a payment or securities settlement system" to "a participant in a system". "Participant" is a more global term, which covers "an institution, a central counterparty, a clearing house or a settlement agent" (Article 2f of the common position). The separate mention of payment and securities settlement system has been replaced by the concept of system, which covers both.

Not only netting is legally enforceable and binding on third parties, even in the event of insolvency, but also transfer orders, meaning that orders in a gross settlement system are also explicitly covered. This applies not only when the transfer order was entered into the system before the opening of insolvency proceedings, but also when it was carried out on the day of opening of insolvency proceedings, unless the system was or should have been aware of the opening of such proceedings. This phrase was added to cover inter alia the following situation: an indirect participant, whose transfer orders are per definition handled by a direct participant, goes bankrupt. The direct participant carries out his transfer orders in good faith, i.e. without knowing that the indirect participant has gone bankrupt just a few moments earlier. It should not be possible to invalidate these transfer orders on the grounds that the indirect participant was bankrupt at the time when his orders were carried out (because of the disruptive effect on the system of such invalidation). Therefore it was necessary to state that these transfer orders carried out on the day of insolvency without knowledge of such insolvency, are enforceable and binding on third parties.

Article 3 (2) of the amended proposal (amendment 16 (2) of Parliament), has been taken over in the common position, with a few clarifications.

The European Parliament's amendment 21 on the moment of *opening of insolvency proceedings*, proposed that it be the moment when the competent authority notifies the national supervisory authorities. Based on this idea, Article 6 of the common position proposes an alternative which is the moment when the relevant judicial or administrative authority *hands down* its decision. This provision stipulates furthermore that this decision shall be notified to the supervisory authority, as was requested by the European Parliament.

Article 4 of the amended proposal (amendment 17 of Parliament), has become article 5 of the common position. The common position refers to a "transfer order", which englobes the "payment order or order for a securities transaction" used in the amended proposal. The mention of "direct participation" has been deleted, "institution" has been replaced by the more generic term "participant" and the word "system" replaces the mention of "a payment or a securities settlement system".

The amended proposal made clear that only revocation "as against the other institutions directly participating in that system" is prohibited. In the Council common position, that portion of the text has been deleted in order to make the provision more readable. Recital 13, however, makes clear that "nothing in this Directive shall prevent a participant or a third party from exercising any right or claim ...as long as this does not lead to ...the revocation of the transfer order *in the system* (or in other words, against the other participants in that system)". In its common position, the Council took the view that it was unnecessary to state explicitly in the Directive that this rule also applies in the event of an insolvency.

Article 5 of the amended proposal (amendment 18 of Parliament) has become article 7 of the common position, with only a few modifications. The reference to "direct" participation is deleted. The term "institution" is replaced by "participant", a more global term and the separate mention of payment and securities settlement system has been replaced by the concept of system, which covers both. The second phrase of article 5 of the amended proposal has not been retained in the common position, as the Council felt that this explicit mention would weaken the provision rather than strengthen it.

Article 6 of the amended proposal (amendment 19 of Parliament), has become article 8 of the common position. The reference to “direct participation” is deleted. The term “institution” is replaced by “participant”, a more global term and the separate mention of payment and securities settlement system has been replaced by the concept of system, which covers both. The Council’s common position, instead of referring to the “insolvency law of the country where the system is located”, refers to “the law governing that system”. The first words of this provision (“in the event of insolvency proceedings being opened against a participant in a system”), however, should make it clear that this provision only determines the applicable insolvency law. Thus, the European Parliament’s suggestion to delete this provision has not been followed by the Council, since this is considered a crucial element in avoiding conflicts of law.

Article 7 of the amended proposal (amendment 20 of Parliament), has become article 9 of the common position, in a slightly redrafted form. Instead of mentioning an institution or a settlement agent separately, the englobing term of “participant” is used. Moreover, the reference to monetary authorities or to monetary policy has been deleted.

A new provision has been added (Article 9(2) of the common position) in order to clarify the application of the “lex rei sitae” principle in cases where securities are pledged as collateral and where the right of the holder of the collateral is recorded on a register, account or centralised deposit system in another Member State (i.e. dematerialised or immobilised securities).

3.3 CONCLUSIONS

The Commission takes the view that the text of the common position retains the essence of the Commission’s proposal as well as of the European Parliament’s amendments. Therefore, the Commission can commend this common position to the European Parliament.