FINANCIAL COLLATERAL
ARRANGEMENTS

SERIES LAW OF BUSINESS AND FINANCE

Editors

Sebastian Kortmann

Dennis Faber

Volume 9

FINANCIAL COLLATERAL ARRANGEMENTS

**THE EUROPEAN COLLATERAL DIRECTIVE CONSIDERED
FROM A PROPERTY AND INSOLVENCY LAW PERSPECTIVE**

AN ACADEMIC ESSAY IN LAW

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ACCORDING TO THE DECISION OF THE COUNCIL OF DEANS
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PREFACE BY THE SERIES' EDITORS

The Business and Law Research Centre, established in 1994, is a leading research institute in the fields of commercial and private law, and is recognised by the Royal Dutch Academy of Sciences. Participants in the Research Centre include the Faculty of Law of the University of Nijmegen as well as a number of prominent companies and law firms.

Partly as a consequence of the introduction of the euro, the cross-border use of collateral has increased considerably. At present, it seems that this growth will continue. The European Commission has foreseen this development, and in addition to the Settlement Finality Directive of 1998, has enacted the European Collateral Directive in 2002 in order to facilitate the development of a liquid cross-border cash and securities market in the European Union. The European Collateral Directive, which has become so important to the financial markets, is the subject of the doctoral thesis of Thomas Keijser. This directive offers a framework for collateral arrangements in the European Union and addresses a number of issues of property and insolvency law, the practical and theoretical implications of which are examined by Keijser. His study clearly illustrates the ever increasing influence of European law on national systems of private law and the resulting frictions this influence causes.

We feel privileged to have this doctoral dissertation published in our Series and hope that it will find its way to legal practitioners and scholars throughout Europe.

Nijmegen, The Netherlands,
May 2006

Professor Sebastian Kortmann
Chairman of the Board of the
Business and Law Research Centre

Dennis Faber
Director of the Business
and Law Research Centre

SUMMARY TABLE OF CONTENTS

ABBREVIATIONS	XXIII
I INTRODUCTION	1
1. Introductory remarks	1
2. The European Collateral Directive	2
3. Presentation of questions	3
4. Some additional remarks	7
II THE MARKET	9
1. Introduction	9
2. What is financial collateral?	10
3. Master agreements	20
4. Flows of cash and securities in repos and securities lending	25
5. Cross-product arrangements	40
6. Commercial market participants	48
7. Central banks	53
8. The Collateral Directive	64
9. Implementation of the Collateral Directive in the Netherlands	86
III TRANSFER OF TITLE	93
1. Introduction	93
2. Transfer of title: the market approach	100
3. Recharacterisation as a security interest?	112
4. Temporary transfer of title?	164
5. Conclusion	171
IV RIGHT OF USE	175
1. Introduction	175
2. Right of use under American law	186
3. Right of use under English law	199
4. Right of use under Dutch (and German) law	214
5. Conclusion	261

V	ENFORCEMENT	275
1.	Introduction	275
2.	The liberal enforcement of a security interest and the abolition of the prohibition of appropriation	279
3.	Close-out netting	290
4.	The declaration of insolvency: no retroactive effect, enforceability of legal acts	313
5.	Freeze period	325
6.	Conclusion	334
VI	CONCLUSION AND RECOMMENDATIONS	339
1.	Introduction	339
2.	The consequences for property and insolvency law	340
3.	Restrictive or extensive scope of application?	352
4.	Recommended changes to the Collateral Directive and the Settlement Finality Directive	361
	SUMMARY	365
	SAMENVATTING	369
APPENDIX I	TEXT OF THE SETTLEMENT FINALITY DIRECTIVE	373
APPENDIX II	TEXT OF THE COLLATERAL DIRECTIVE	383
	BIBLIOGRAPHY	397
	LEGISLATION, GUIDELINES AND PRINCIPLES	417
	LEGISLATIVE HISTORY OF THE COLLATERAL DIRECTIVE	421
	WEBSITES	423
	SUBJECT INDEX	425

TABLE OF CONTENTS

ABBREVIATIONS	XXIII
I INTRODUCTION	1
1. Introductory remarks	1
2. The European Collateral Directive	2
3. Presentation of questions	3
4. Some additional remarks	7
II THE MARKET	9
1. Introduction	9
1.1 Introductory remark	9
1.2 Financial products	9
1.3 Market participants	9
1.4 Legislative framework	10
2. What is financial collateral?	10
2.1 Introduction	10
2.2 The financial products	10
2.2.1 Repurchase transactions	11
2.2.2 Securities lending transactions	12
2.2.3 Derivatives transactions	14
2.3 Title transfer or security interest	15
2.4 Two functions of financial collateral	16
2.4.1 Recovery and tradeability	16
2.4.2 The title transfer method	17
2.4.3 The security interest method	18
2.4.4 Terminology	19
3. Master agreements	20
3.1 Introduction	20
3.2 Repos	20
3.3 Securities lending	22
3.4 Derivatives	23
4. Flows of cash and securities in repos and securities lending	25
4.1 Introduction	25
4.2 Initial and final flows	26

4.2.1	Repos	26
4.2.2	Securities lending	28
4.3	Margin maintenance	28
4.3.1	Introduction	28
4.3.2	Repos	29
4.3.3	Securities lending	33
4.4	Substitution	34
4.5	Income payments	35
4.6	Interest	37
4.6.1	Price differential and lending fee	37
4.6.2	Cash collateral	37
4.6.3	Interest on other sums due	38
4.7	Events of default	38
5.	Cross-product arrangements	40
5.1	Introduction	40
5.2	Bridge provisions	41
5.2.1	Introduction	41
5.2.2	ISDA Cross-Agreement Bridge	41
5.3	Single master agreement for multiple financial products	42
5.3.1	Introduction	42
5.3.2	European Master Agreement	42
5.4	'Master master' agreements	45
5.4.1	Introduction	45
5.4.2	Cross-Product Master Agreement	45
5.5	Practical application	47
6.	Commercial market participants	48
6.1	Introduction	48
6.2	The March 2001 Proposal for a Collateral Directive	48
6.3	The final text of the Collateral Directive	49
7.	Central banks	53
7.1	Introduction	53
7.2	Monetary reverse transactions	53
7.2.1	Monetary policy framework	53
7.2.2	The central role of reverse transactions	58
7.3	The management of foreign reserve assets of the ECB	62
8.	The Collateral Directive	64
8.1	Introduction	64
8.2	Scope of the Collateral Directive	65
8.2.1	Introduction	65
8.2.2	Financial collateral	66
8.2.3	Requirements	67

8.2.4 Market participants	69
8.2.5 Interpretation of the Collateral Directive: two functions of collateral	70
8.3 Title transfers: no recharacterisation	71
8.4 Security interests: right of use	72
8.5 Margin transfers	74
8.6 Substitution	76
8.7 Manner of enforcement	77
8.7.1 Introduction	77
8.7.2 Security interests: a liberal enforcement regime	78
8.7.3 Title transfers: close-out netting	81
8.8 Insolvency law	82
8.8.1 Introduction	82
8.8.2 The declaration of insolvency has no retroactive effect	83
8.8.3 Protection after the declaration of insolvency	83
8.8.4 No freeze period	84
8.8.5 The favourable position of the collateral taker	84
8.9 Conclusion	84
9. Implementation of the Collateral Directive in the Netherlands	86
9.1 Introduction	86
9.2 General remarks	87
9.2.1 Some definitions	87
9.2.2 Scope of applicability	87
9.3 Title transfer and right of use	88
9.3.1 Title transfers	88
9.3.2 Right of use	89
9.4 Enforcement	89
9.4.1 Enforcement of a right of pledge	89
9.4.2 Close-out netting	90
9.4.3 Insolvency law	90
III TRANSFER OF TITLE	93
1. Introduction	93
1.1 Contents	93
1.2 Terminology	94
1.3 Core characteristics of security interests	97
2. Transfer of title: the market approach	100
2.1 Introduction	100
2.2 The approach of the standard documentation	100
2.3 Repos under Dutch law	101

2.4 Securities lending under Dutch law	103
2.4.1 Market practice	103
2.4.2 A loan of fungibles: transfer of ownership	107
2.5 The different legal structures of repo and securities lending transactions	108
2.6 Margin arrangements	109
2.6.1 Margin transfers	109
2.6.2 Repricing and adjustment	111
2.7 Substitution	111
2.8 Conclusion: an outright transfer of title is the market standard	112
3. Recharacterisation as a security interest?	112
3.1 Introduction	112
3.2 Security interests in the Netherlands and Germany	115
3.2.1 Introduction	115
3.2.2 Security interests under the old Dutch Civil Code	115
3.2.3 Security interests under the German Civil Code	119
3.2.4 The abolition of fiduciary transfers of title in the new Dutch Civil Code	123
3.3 Recharacterisation risk: a function-based approach	125
3.3.1 Introduction	125
3.3.2 The functions of title transfers as opposed to security interests	125
3.3.3 The functions of financial collateral	131
3.3.4 Conclusion	134
3.4 The <i>Sogelease</i> decision	135
3.4.1 The contents of the <i>Sogelease</i> decision	135
3.4.2 The merits and deficiencies of the <i>Sogelease</i> decision	139
3.4.3 The <i>Sogelease</i> decision and repo and securities lending agreements	147
3.4.4 The <i>BTL Lease</i> decision	150
3.4.5 Conclusion	151
3.5 Subsidiary right of pledge	152
3.6 Article 2a of the STSA	154
3.6.1 Introduction	154
3.6.2 Genuine repos only	155
3.6.3 Purchased and margin securities	156
3.6.4 Securities lending transactions	157
3.6.5 Other collateralised transactions	158
3.6.6 Hold-in-custody transactions	159

3.6.7 The Netherlands Annex to GMRA 1995 and GMRA 2000: deletion of the subsidiary right of pledge	159
3.6.8 Conclusion	160
3.7 The Collateral Directive	160
3.7.1 Article 6 of the Collateral Directive	160
3.7.2 Implementation in the Netherlands	162
4. Temporary transfer of title?	164
4.1 Introduction	164
4.2 The non-applicability of Article 3:85 of the NCC	166
4.3 Recovery function	168
4.4 Income payments and voting rights	169
4.5 The Collateral Directive	170
4.6 Conclusion	170
5. Conclusion	171
5.1 Market standard	171
5.2 Recharacterisation as a security interest?	171
5.3 Temporary transfer of title?	173
IV RIGHT OF USE	175
1. Introduction	175
1.1 Introductory remarks	175
1.2 The title transfer method	177
1.3 The security interest approach	177
1.3.1 Article 5 of the Collateral Directive	178
1.3.2 The 'horizontal' and 'vertical' relationships	179
1.3.3 A right of use in Europe – Why?	181
1.4 Other issues	185
1.4.1 Income payments and voting rights	185
1.4.2 Accounting, capital adequacy, and registration by custodians	185
1.4.3 Tax	185
2. Right of use under American law	186
2.1 Introduction	186
2.2 Impairing repledge: the margin lending practice and the UCC	188
2.3 A secured party's general right of disposal: the securities lending and derivatives markets	190
2.4 Remarkable characteristics	194
2.4.1 Introduction	194
2.4.2 No equity of redemption	194
	XV

2.4.3 Duty of reasonable care	195
2.4.4 Residual rights?	195
2.4.5 No interest in the proceeds	196
2.5 The characterisation issue	197
2.6 Conclusion	198
3. Right of use under English law	199
3.1 Introduction	199
3.2 Prime brokerage and custody	200
3.2.1 Introduction	200
3.2.2 Prime brokerage	201
3.2.3 The client – custodian relationship	202
3.3 The approach of the standard documentation	203
3.4 Theoretical considerations	203
3.4.1 Introduction	203
3.4.2 'Once a mortgage, always a mortgage', and the equity of redemption	204
3.4.3 No collateral benefits	206
3.4.4 Residual rights?	206
3.4.5 An interest in proceeds or equivalent assets?	207
3.4.6 Concluding remarks	208
3.5 Additional arguments for change?	209
3.6 The Financial Collateral Arrangements (No. 2) Regulations 2003	211
3.7 Conclusion	212
4. Right of use under Dutch (and German) law	214
4.1 Introduction	214
4.1.1 Market practice before the Collateral Directive	214
4.1.2 A new construction: a security interest combined with a general right of disposal	214
4.1.3 Contents of section 4	214
4.2 Enforcement	215
4.3 Repledge	216
4.3.1 Dutch law	216
4.3.2 German law	217
4.3.3 Conclusion	218
4.4 Perishable goods	218
4.5 A non-owner's right of disposal granted on a contractual basis	221
4.5.1 Introduction	221
4.5.2 Sale on commission	225
4.5.3 Reservation of title arrangements	227

4.5.4 Fiduciary transfer of title	229
4.5.5 A pledgee's contractually granted general right of disposal?	231
4.6 Irregular structures	235
4.6.1 Introduction	235
4.6.2 Irregular right of pledge	235
4.6.3 Irregular right of usufruct	239
4.6.4 The moment that ownership passes: residual rights for the original owner?	246
4.6.5 To whom does ownership pass?	250
4.7 Proprietary substitution	251
4.7.1 Introduction	251
4.7.2 Article 5 of the Collateral Directive	252
4.7.3 Practical effects?	252
4.7.4 Compatibility with Dutch property law?	253
4.7.5 Alternatives?	255
4.8 Implementation in Germany and the Netherlands	256
4.9 Concluding remarks	258
5. Conclusion	261
5.1 Introductory remarks	261
5.2 The security interest approach	262
5.2.1 General considerations	262
5.2.2 United States	263
5.2.3 Europe	263
5.2.4 Vertical relationships	267
5.2.5 Theory and its meaning in practice	268
5.2.6 Future developments?	269
5.2.7 Conclusion	270
5.3 The title transfer approach	270
5.4 Other issues	271
5.5 Concluding remarks	272
V ENFORCEMENT	275
1. Introduction	275
1.1 Introductory remark	275
1.2 The manner of enforcement	275
1.3 Insolvency law	276
1.4 Who benefits from the enforcement regime of the Collateral Directive?	277

2. The liberal enforcement of a security interest and the abolition of the prohibition of appropriation	279
2.1 Introduction	279
2.2 The enforcement of a security interest without formal requirements	279
2.2.1 The traditional approach	279
2.2.2 The liberal approach of the Collateral Directive	283
2.2.3 Implementation in the Netherlands	285
2.3 No prohibition of appropriation?	288
3. Close-out netting	290
3.1 Introduction	290
3.1.1 What is netting?	290
3.1.2 Close-out netting under GMRA and GMSLA	291
3.1.3 The approach of the Collateral Directive and the role of national law	291
3.1.4 The approach of the Dutch legislator	293
3.1.5 The contents of this section	296
3.2 Reciprocity or mutuality	296
3.2.1 Introduction	296
3.2.2 A note on terminology	296
3.2.3 Dutch law	297
3.2.4 European Principles of Contract Law	297
3.2.5 UNIDROIT Principles	298
3.2.6 Contractual arrangements and insolvency	298
3.2.7 The Collateral Directive and the role of national law	299
3.3 Similarity or commensurability	299
3.3.1 Introduction	299
3.3.2 Dutch law	300
3.3.3 European Principles of Contract Law	300
3.3.4 UNIDROIT Principles	301
3.3.5 Contractual arrangements and insolvency	302
3.3.6 The Collateral Directive and the role of national law	302
3.4 Voidable preference	303
3.5 Moment of valuation	304
3.5.1 Introduction	304
3.5.2 GMRA and GMSLA	304
3.5.3 Fixation principle	305
3.5.4 Netherlands Annex to GMRA 2000	306
3.5.5 Article 38 of the NBC	306
3.5.6 § 104 of the German Insolvency Statute	308

3.5.7 Comparison with pledge law	311
3.5.8 Concluding remark	311
3.6 Conclusion	312
4. The declaration of insolvency: no retroactive effect, enforceability of legal acts	313
4.1 Starting point: retroactive effect, no enforceability of legal acts	313
4.2 The declaration of insolvency has no retroactive effect	313
4.3 Enforceability of legal acts after the declaration of insolvency	316
4.3.1 Introduction	316
4.3.2 General principle and four exceptions	317
4.3.3 Pros and cons	322
5. Freeze period	325
5.1 Introduction	325
5.2 The Dutch freeze period	326
5.3 The Settlement Finality Directive and the Collateral Directive	328
5.4 The scope of the Dutch freeze period	329
5.5 Implementation into Dutch law	333
6. Conclusion	334
6.1 Enforcement	335
6.1.1 Enforcement of a security interest	335
6.1.2 Close-out netting	336
6.2 Insolvency law	337
6.2.1 The declaration of insolvency has no retroactive effect	337
6.2.2 Enforceability of legal acts after the declaration of insolvency	337
6.2.3 No freeze period	338
VI CONCLUSION AND RECOMMENDATIONS	339
1. Introduction	339
1.1 Introductory remarks	339
1.2 Overview of consequences for property and insolvency law	339
1.3 Restrictive or extensive interpretation?	340
1.4 Recommendations for change	340
2. The consequences for property and insolvency law	340
2.1 Introduction	340
2.2 Property law	341

2.2.1	Introduction	341
2.2.2	Core characteristics of security interests	341
2.2.3	Transfer of title	342
2.2.4	Security interests	344
2.2.5	Concluding remark	349
2.3	Insolvency law	349
2.3.1	The declaration of insolvency has no retroactive effect	349
2.3.2	Enforceability of legal acts after the declaration of insolvency	350
2.3.3	No freeze period	350
2.4	Who pays the price of enhanced liquidity?	350
3.	Restrictive or extensive scope of application?	352
3.1	Introduction	352
3.2	Market participants	353
3.3	Financial products	356
3.3.1	Introduction	356
3.3.2	Transfer of title	356
3.3.3	Right of pledge	358
3.3.4	The dual function requirement	358
3.4	Conclusion	361
4.	Recommended changes to the Collateral Directive and the Settlement Finality Directive	361
4.1	Introduction	361
4.2	Limitation to major market participants	362
4.3	The abolition of or an amendment to the right of use	363
4.4	Close-out netting	363
4.5	No enforceability of legal acts after the declaration of insolvency	364
4.6	No changes required: retroactive effect of the declaration of insolvency, freeze period	364
SUMMARY		365
SAMENVATTING		369
APPENDIX I TEXT OF THE SETTLEMENT FINALITY DIRECTIVE		373
APPENDIX II TEXT OF THE COLLATERAL DIRECTIVE		383
BIBLIOGRAPHY		397

LEGISLATION, GUIDELINES AND PRINCIPLES	417
LEGISLATIVE HISTORY OF THE COLLATERAL DIRECTIVE	421
WEBSITES	423
SUBJECT INDEX	425

ABBREVIATIONS

BIS	Bank for International Settlements
CD	Collateral Directive ¹
CPMA	Cross-Product Master Agreement
CSSA	Credit System Supervision Act 1992 ²
DNB	De Nederlandsche Bank (i.e. the Dutch central bank)
ECB	European Central Bank
EMA	European Master Agreement
EMU	Economic and Monetary Union
ERC	European Repo Council
ESCB	European System of Central Banks
FBE	Federation Bancaire de l'Union Européenne
GCC	German Civil Code ³
GMRA	Global Master Repurchase Agreement ⁴
GMSLA	Global Master Securities Lending Agreement
ICMA	International Capital Market Association
IRC	International Repo Council
ISDA	International Swaps and Derivatives Association
ISLA	International Securities Lenders Association
ISMA	International Securities Market Association
LIBOR	London Inter-Bank Offered Rate
MEFISLA	Master Equity & Fixed Interest Stock Lending Agreement
MGESLA	Master Gilt Edged Stock Lending Agreement
NBC	Netherlands Bankruptcy Code ⁵
NCB	National Central Bank
NCC	Netherlands Civil Code ⁶
OSLA	Overseas Securities Lender's Agreement
PSA	Public Securities Association
SFD	Settlement Finality Directive ⁷
SGTA	Securities Giro Transfer Act 1995 ⁸
SIA	Securities Industry Association
STSA	Securities Trade Supervision Act ⁹
TBMA	The Bond Market Association
UCC	American Uniform Commercial Code

1 See the list of legislation at the end of this book

2 The Dutch *Wet toezicht kredietwezen* 1992

3 The German *Bürgerliches Gesetzbuch*

4 In this book the abbreviation GMRA refers to the 2000 version of this agreement, unless otherwise indicated

5 The Dutch *Burgerlijk Wetboek*

6 The Dutch *Faillissementswet*

7 See the list of legislation at the end of this book

8 The Dutch *Wet giraal effectenverkeer*

9 The Dutch *Wet toezicht effectenverkeer* 1995

INTRODUCTION

1. INTRODUCTORY REMARKS

This study deals with financial collateral arrangements. Such arrangements relate to cash and securities and are typically entered into by banks and other major players on the financial markets. Their importance becomes clear when considering some of the main examples of financial collateral arrangements: repurchase ('repo') and securities lending agreements, which are instruments for parties to provide each other with cash and/or securities. These financial products are of key importance for the liquidity of the cash and securities markets in the European Union. Central banks use them as their main tool to conduct their monetary policy, and they are also applied on a large scale by participants in commercial markets. The size of the commercial repo and securities lending markets in Europe is measured every half year in the European Repo Market Survey, which shows how significant these markets are. According to the Survey conducted on 7 December 2005, there was a total amount of 5883 billion euro of outstanding repo and securities lending transactions in the commercial markets at that moment.¹ Another major market that features transactions in which financial collateral is often provided is the derivatives market. The repurchase and securities lending markets, in particular, and to a somewhat lesser extent, the derivatives market will be used throughout this book as illustrations of what financial collateral arrangements are about.

This study will focus on a number of important legal issues in relation to financial collateral arrangements. In the European Union, the so-called Collateral Directive² sets out a legal framework for repurchase, securities lending and other collateralised arrangements. This directive requires Member States to harmonise a number of issues of property and insolvency law. This book analyzes the most important of these issues from the perspective of Dutch law. For historical reasons, some attention will also

1 See www.icma-group.org.

2 Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, *Official Journal* L 168, 27 June 2002, pp. 43-50. See also the list of legislation at the end of this book.

be paid to American and English law. Moreover, comparisons will be made between Dutch and German law on account of their similarity. The rest of this introduction will give further insight into the issues examined in this book.

2. THE EUROPEAN COLLATERAL DIRECTIVE

In October 1998, the European Commission issued a Communication titled 'Financial Services: Building a Framework for Action'.³ In this Communication, the Commission pointed out several areas in which action was required to establish an integrated European market for financial services upon the introduction of the single currency, the euro. The markets for collateralised transactions were mentioned as an important point of attention:

The introduction of the euro will increase the number of transactions involving cross-border use of collateral. We must therefore ensure that collateral provisions are mutually compatible to avoid undue disturbances to financial markets, and potential repercussions for the EU economy at large.⁴

In its subsequent Action Plan of May 1999, entitled 'Financial Services: Implementing the Framework for Financial Markets', the Commission labelled the formulation of a European directive on the cross-border use of collateral as a priority, deserving immediate attention. With this directive, the Commission intended to facilitate the development of a liquid cross-border cash and securities market in the European Union. The introduction of a directive relating to collateral can be considered as a follow-up to the Settlement Finality Directive of 1998,⁵ which relates to the finality of payments of book-entry cash and securities in designated settlement systems. Both directives aim at an optimally functioning financial market in the European Union. Particularly in the field of insolvency law, the approaches of the Settlement Finality Directive and the Collateral Directive coincide.

3 See the list of documents that appeared in the course of the legislative history of the Collateral Directive at the end of this book

4 See section 43 of the Financial Services Framework for Action

5 Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on Settlement Finality in Payment and Securities Settlement Systems, *Official Journal* L 166, 11 June 1998, pp 45-50. See also the list of legislation at the end of this book

The text of the European Collateral Directive was initially developed by a Forum Group on Collateral and subsequently amended several times in the course of the legislative process. The final text of the Collateral Directive entered into force on 27 June 2002, the day of its publication in the *Official Journal of the European Communities*. It sets out the legislative framework for agreements (such as repurchase and securities lending agreements) relating to financial collateral in the European Union. Officially, the final date for its implementation into the national laws of the Member States was 27 December 2003. Many Member States, however, had not implemented the directive by 2004 (or even 2006), largely because of the directive's complexity and far-reaching consequences.

The Collateral Directive relates to 'financial collateral arrangements', which term refers to arrangements whereby parties provide each other with cash and/or securities for an agreed period of time in order to cover an exposure. The directive was primarily written for transactions between big players on the capital markets, such as commercial and central banks, insurance companies, investment funds, certain government bodies, etc., the main goal being to stimulate the liquidity of European cash and securities markets. In order to facilitate cross-border transactions, and thereby to stimulate liquidity, the directive requires Member States to harmonise certain provisions of property and insolvency law.

3. PRESENTATION OF QUESTIONS

This study focuses on the aforementioned issues of property and insolvency law because they play an important role in financial collateral arrangements. For example, parties want to know which requirements to meet in order to safely provide financial collateral and what rules to comply with in the event of their counterparty's default, specifically if this is caused by insolvency. This is reflected in the Collateral Directive, which is intended to provide clear and uniform rules of property and insolvency law in relation to financial collateral arrangements on a European level. Note that the focus on property and insolvency law excludes a number of other important issues that arise in connection with financial collateral arrangements, such as the tax and accounting treatment thereof and the capital adequacy requirements to which these arrangements give rise. It should also be noted that issues of private international law are not considered here. The applicability of (mandatory) Dutch rules of property and insolvency law is presumed.

This leads us to the questions that will be discussed in this study. After an overview in chapter II of the markets in which financial collateral arrangements occur, the focus will be on the most important issues of property and insolvency law that arise in connection with the Collateral Directive. Chapters III and IV examine the two methods used for providing collateral: the title transfer method (chapter III) and that of a security interest combined with a collateral taker's general right of disposal (the so-called 'right of use'), which is critically examined in chapter IV. Chapter V outlines the consequences of the Collateral Directive for enforcement by considering the way in which financial collateral is enforced by a collateral taker in the event of default, as well as a number of mandatory changes to insolvency law. A central theme throughout this book is the question of whether the scope of the Collateral Directive should be limited, and if so, how. This theme is given particular attention in chapter VI. The contents of chapters II, III, IV, V and VI will now be outlined in more detail.

Before it is possible to analyse the legal issues at stake, it is necessary to give a more economic and technical overview of the markets in which financial collateral arrangements are applied. This is done in chapter II. The first sections of this chapter provide an overview of financial products, and explain what financial collateral actually is. They proceed to outline the master agreements that are commonly used to document repurchase, securities lending and derivatives transactions and describe the flows of cash and securities that take place in such transactions. Attention will also be given to cross-product arrangements, which link flows of cash and securities under different financial products, such as repurchase and securities lending agreements. The following two sections identify the most significant commercial market participants, as well as examine the importance of financial collateral for central banks. The legislative framework is the focus of the last few sections, which give an outline of the Collateral Directive and deal with the most important issues relating to the implementation of the Collateral Directive in the Netherlands.

Financial collateral can be provided in two different ways. The focus of chapter III is the title transfer method, which is the international market standard for the provision of financial collateral. Particular attention is paid to the following question: under what circumstances does a transfer of title run the risk of being recharacterised as a security interest, or as a transaction having a defective underlying *causa*? This chapter also discusses whether a transfer of financial collateral should not be characterised as a temporary transfer of title.

Chapter IV deals with the second method to provide financial collateral envisaged by the Collateral Directive. The directive makes it possible to establish a security interest combined with a general right of disposal for the collateral taker (a so-called 'right of use'). This innovation, which has primarily been inspired by a comparable development in the American market, is critically examined in this chapter.

Chapter V relates to the consequences of the Collateral Directive for the enforcement of financial collateral. A distinction is made between the consequences for the way in which financial collateral is enforced and a number of issues of insolvency law. The first important theme that is discussed in chapter V is the liberal enforcement regime that the Collateral Directive prescribes in relation to financial collateral. This regime becomes particularly evident when one considers the effects of the Collateral Directive on the enforcement of a security interest. The directive abolishes essential features of security interests, such as the prescribed manner of enforcement and the prohibition of appropriation. If financial collateral has been provided by way of a title transfer, enforcement takes place by way of close-out netting, which is subsequently discussed.

A second important theme discussed in chapter V covers the changes that the Collateral Directive requires in the field of insolvency law, in which the Collateral Directive extends the approach of the earlier Settlement Finality Directive. Under the Settlement Finality Directive and the Collateral Directive, a declaration of insolvency has no retroactive effect. Both directives also contain provisions that offer a level of protection against the effects of insolvency to the counterparty of an insolvent entity – even in respect of legal acts that have been carried out after the declaration of insolvency. Additionally, these directives require the abolition of a freeze period in relation to transactions in settlement systems and with financial collateral.

An important theme throughout this study is the desirable scope of applicability of the Collateral Directive and the Dutch Law implementing Directive 2002/47/EC on financial collateral arrangements (hereafter referred to as 'the Dutch implementing law').⁶ This issue is relevant because the Collateral Directive has a number of far-reaching consequences for systems of property and insolvency law, which are generally more favourable to creditors/security takers and more detrimental to debtors/

6 See *Staatsblad* 2006, 15 and *Staatsblad* 2006, 16.

security providers. The Dutch Council of State (*Raad van State*) hit the nail on the head when it stated:

Moreover, the directive deviates on a number of issues from the rules in respect of the right of pledge as set out in Book 3 of the NCC, and provides the creditor pledgee with a number of extra securities at the expense of the debtor/pledgor. Also the proposed amendments to the Bankruptcy Code signify an important change in the position of the creditors of the insolvent estate to the benefit of the creditor under a financial collateral agreement.⁷

It is apparent from the provisions of both property and insolvency law of the Collateral Directive and the Dutch implementing law that, in general, these legislative initiatives enforce the position of credit providers and have a negative impact on the position of collateral providers. This is particularly disturbing if collateral providers, who are in a dependent position anyway because they are in need of funding, are relatively powerless small and medium-sized enterprises. In light of such far-reaching consequences, the question of the scope of the Collateral Directive and national implementing laws requires careful examination: is it desirable to limit this scope and, if so, how should this be done?

There are, broadly speaking, two ways to limit the scope of the legislative initiatives mentioned. The first relates to market participants. The Collateral Directive is primarily designed for transactions between major market participants but also leaves room for applying its provisions to transactions between these major market participants and other enterprises, including small and medium-sized enterprises. A second option would be to limit the scope to financial transactions that meet certain functional requirements. As arguments for either an extensive or restrictive interpretation can only be made after a thorough analysis of the consequences of the Collateral Directive and the Dutch implementing law, this issue will be discussed at the end of this book, in chapter VI. This latter chapter also contains a number of recommendations for changing the Collateral Directive and the Settlement Finality Directive so as to restore the balance

⁷ See *Tweede Kamer*, 2002-2003, 28 874, B, p. 2. Translation: TK. Original Dutch text: 'De richtlijn wijkt bovendien op een aantal punten af van de regeling van het pandrecht in Boek 3 BW en verschaft aan de crediteur pandhouder een aantal extra zekerheden ten koste van de debiteur/pandgever. Ook de voorgestelde wijzigingen van de Faillissementswet betekenen een belangrijke wijziging in de posities van de faillissementscrediteuren ten gunste van de crediteur uit een financiële zekerheids-overeenkomst.'

between collateral provider and collateral taker, and between the creditors of an insolvent estate.

4. SOME ADDITIONAL REMARKS

While the central focus throughout this book is the Dutch legal analysis, American, English and German law also play a role in this study. The discussion of American and English law mainly serves to provide some historical background of the issue. Financial collateral arrangements blossomed first in these legal systems, and the internationally applied standard agreements to document such arrangements were developed in these jurisdictions. Special attention is given to American and English law in chapter IV in considering a security interest combined with a general right of disposal, because these are the jurisdictions that seem to have inspired the introduction of this construction in the European Union. In a number of instances, German law has been used as a comparative, as is evident throughout chapters III, IV and V. These comparisons strengthen the argument in respect of Dutch law because they make it possible to address precisely the same issues from a similar, but somewhat different perspective.

While this book has been written primarily for lawyers, it is not meant only for those who are financial market practitioners; it is also intended for lawyers who are less familiar with financial collateral arrangements. As the main focus of this book is Dutch law, Dutch lawyers are the primary target group. However, because the issues of property and insolvency law discussed here are also relevant in many other European countries, this book has been written in English in order to make this information accessible to foreign readers. Another reason for choosing English is that this is the language that is commonly used in financial markets.

In order to facilitate the reader, this book contains appendices with the texts of the Settlement Finality Directive and the Collateral Directive. The sources consulted have been set out in a bibliography and in an overview of legislative acts, guidelines and principles discussed (including a short outline of the subject matter of each). A full list of the official documents that have led to the adoption of the Collateral Directive has been included, as well as a list of some useful websites. For further reference, a subject index is provided at the end of this study.

Unless mentioned otherwise, this book takes into account materials that have appeared up to and including January 2006, by which time the Collateral Directive had been implemented in the countries that play a central role in this study, i.e. the United Kingdom (December 2003), Germany (April 2004) and the Netherlands (January 2006). In the Netherlands, the first draft law for implementing the Collateral Directive was rejected by the First Chamber of Parliament in March 2005, because it envisaged legislation wider in scope than that of the Collateral Directive because it included transactions between enterprises. A revised law for implementing the Collateral Directive, with a more limited scope of applicability, was published and came into force on 20 January 2006.⁸

8 See *Staatsblad* 2006, 15 and *Staatsblad* 2006, 16.

CHAPTER II

THE MARKET

1. INTRODUCTION

1.1 Introductory remark

This chapter provides an overview of the markets in which financial collateral arrangements are entered into. Sections 2, 3, 4 and 5 present the financial products involved. Sections 6 and 7 describe the most important market participants. The last sections of this chapter outline the legislative framework for collateralised transactions. A further analysis of certain issues of property and insolvency law is made in chapters III, IV and V.

1.2 Financial products

Section 2 below examines what financial collateral actually is. Repo and securities lending transactions are examples of collateralised transactions. Financial collateral may also play a role in derivatives transactions. The term 'collateral' has a special meaning for the purposes of these financial instruments. In addition to having a recovery function, it usually enhances the liquidity of the financial markets.

Section 3 deals with special standard agreements that have been developed for use in the commercial markets in order to document repurchase, securities lending and derivatives transactions. These agreements demonstrate the flows of cash and securities that commonly take place in repo and securities lending transactions (section 4). Market needs have also given rise to standardised 'cross-product' agreements. Cross-product arrangements are designed to link flows of cash and securities in different financial products (in repo and securities lending transactions, for instance) and are the topic of section 5.

1.3 Market participants

While the use of financial collateral arrangements in the commercial markets is the focus of section 6, the use of financial collateral by central

banks in the course of their monetary policy operations and the management of their foreign reserve assets is reviewed in section 7.

1.4 Legislative framework

The European Collateral Directive, the topic of section 8, is intended to harmonise legal issues that are relevant in the case of financial collateral arrangements. It relates to the provision of financial collateral by way of a title transfer or by way of a security interest combined with a right of use. It also contains a simplified regime for the enforcement of financial collateral and a number of rules of insolvency law. The Dutch law implementing the Collateral Directive is outlined in section 9 below.

2. WHAT IS FINANCIAL COLLATERAL?

2.1 Introduction

This section examines a number of different financial products in which financial collateral is used, it sets out the two methods of providing financial collateral, and it takes a look at the two functions that such collateral fulfils.

2.2 The financial products

This section outlines the most important financial products that make use of financial collateral, namely repurchase agreements, securities lending agreements and derivatives. The market has developed standard 'master' agreements that are used to document these financial products. The master agreements serve as a framework under which individual transactions can be concluded. These master agreements contain general provisions that apply to all transactions concluded under that agreement, but can also be complemented with specific provisions for each individual transaction. The most important of these agreements, which are used internationally, are the Global Master Repurchase Agreement (GMRA) for repurchase transactions, the Global Master Securities Lending Agreement (GMSLA) for securities lending transactions and the International Swaps and Derivatives Association's (ISDA) Master Agreements for the documentation of derivatives transactions. These and other domestic agreements are further discussed in section 3 below. This section outlines the

basic structure of repurchase, securities lending and certain derivatives transactions.¹

2.2.1 Repurchase transactions

Repurchase, or, in short, 'repo' transactions can be defined as transactions in which party A (the seller) transfers certain securities sold to party B (the buyer) for an amount of cash (the purchase price) at moment T, while B agrees to sell and transfer equivalent securities at a future moment T+X for a certain amount of money, including an interest component (the repurchase price). The need for cash is usually the principal reason for entering into a repo, thus the principal flow is the cash flow at the outset of the transaction. The collateral flow is defined as the flow of securities in return for this principal flow.

Graphically, a repo transaction can be depicted as follows:²

Repurchase transaction

In the course of a repurchase transaction, the value of securities or cash provided earlier in the course of the transaction may change. These price fluctuations can lead to a net exposure of one of the parties. A net exposure can be defined as the risk that one of the parties to an agreement faces in respect of his counterparty. This risk is calculated by netting the monetary value of all mutual rights and obligations under one or more transactions concluded under that agreement. In order to eliminate this

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- 1 For a legal analysis of the structure of repurchase and securities lending transactions under Dutch law, see sections 2 3 and 2 4 of chapter III
 - 2 This is a simplified reproduction, in which payment obligations arising in the course of a transaction, in connection with price fluctuations or dividend and other income payments, have not been taken into account

net exposure arising from price fluctuations, transfers of collateral cash and/or securities may be made in the course of repo transactions. Such transfers are usually referred to as margin transfers. The standard master agreements for repos determine how much margin collateral should be provided, in what manner, at what time, etc.³

There is a variety of different forms of repos, each developed for a specific purpose. For example, 'intra-day' repos are terminated on the same day that they are entered into, 'overnight' repos are concluded for one night only, whereas 'term' or 'open' repos are concluded with or without a fixed ending date. In addition, buy/sell back transactions, in which party A buys securities from party B, while being under an obligation to sell equivalent securities to B at a later date, may be seen as a form of repo. Traditionally, however, the structure of a buy/sell back transaction is simpler than that of a repo. For example, margin transfers, as a rule, do not take place in the course of a buy/sell back transaction.⁴

Sometimes a distinction is made between 'repurchase' and 'reverse repurchase' agreements or transactions. While both terms refer to exactly the same agreement or transaction, they reflect the different perspectives of the seller and the buyer respectively. In a 'repurchase' agreement or transaction, the seller is obliged to repurchase equivalent securities at $T+X$. The term 'reverse repurchase' relates to the opposing point of view held by the buyer. In this study, the distinction between repurchase and reverse repurchase agreements or transactions is not made, unless indicated otherwise.

2.2.2 *Securities lending transactions*

In a securities lending transaction, borrower A receives specific securities from lender B for an amount of cash or other securities at moment T , while the lender and borrower commit themselves to transferring equivalent securities and/or cash at a later moment $T+X$. At this moment, the borrower usually pays an interest component also. The need for specific securities is the main reason for entering into securities lending transactions. The flow of securities from lender to borrower is, therefore, the principal flow. The collateral flow at the outset of a transaction can be defined as the flow of securities and/or cash in a direction opposite from

3 See also section 4.3 below.

4 On the differences between repos and buy/sell back transactions, see Brown 1996 II and Corrigan / Georgiou / Gollow 1999, chapter 2.

this principal flow. Graphically, a securities lending transaction can be represented as follows:⁵

Securities lending transaction

A net exposure, as described above, may also arise in the course of a securities lending arrangement. As with repos, the standard documentation for securities lending agreements also provides for the elimination of such a net exposure by way of margin transfers.⁶

The main difference between repos and securities lending is that in a repo, the need for cash is usually the principal reason for entering into transactions, while in the case of securities lending, it is the need for certain securities that leads to deals between parties. Other differences between repos and securities lending follow from this main difference. For example, in a repo, the seller (who received cash) is obliged to pay interest at the end of a transaction, while in the case of securities lending, the borrower (who received a specific type of security) usually pays interest.⁷

Sometimes a distinction is made between the term 'securities lending' and 'securities borrowing'. These terms reflect the perspective of the lender and the borrower respectively. This study generally uses the term 'secu-

5 Payment obligations arising in the course of a transaction due to price fluctuations in the market and income payments have not been taken into account.

6 See also section 4.3 below.

7 For a further elaboration of the differences between repos and securities lending arrangements see Brown 1996 III, pp. 51-52; Steiner 1997, pp. 69-118; Corrigan / Georgiou / Gollow 1999, chapter 2.

rities lending' and does not make this distinction, unless indicated otherwise.

2.2.3 Derivatives transactions

Derivatives agreements and transactions play a less prominent role in this study than repurchase and securities lending arrangements. Still, there are good reasons to pay some attention to derivatives.

First, certain types of derivatives transactions have a structure that is comparable to that of a repurchase or securities lending transaction. As with a repurchase or securities lending transaction, in certain derivatives transactions parties also transfer cash and/or securities at moment T, while agreeing that they will transfer equivalent assets at moment T+X. An example of such a derivatives transaction is a currency swap, in which A transfers dollars to B at moment T in exchange for euros. The amounts paid at the outset of a transaction are the 'principal amounts'. Until maturity at T+X, the parties commit themselves to a periodical exchange of interest payments received on the swapped currencies. The parties also agree that upon the maturity date of the transaction, they will pay amounts equivalent to the principal amounts in the same currency.⁸ A currency swap transaction appears as follows:⁹

Currency swap transaction

8 The Corporate Finance Risk Management & Derivatives Yearbook 1995, p XIV, defines a currency swap as follows 'The spot sale/purchase of one currency for another combined with a simultaneous forward agreement to repurchase the agreed currency amounts at a preset date and an agreement by the counterparties to exchange the interest payments on their swapped currencies ' See also Gooch / Klein 2002, p 505 *et seq.*, and Nijenhuis 1998, section 2

9 Obligations to pay interest in the course of the transaction have not been reflected in this diagram

It should be noted that the term 'derivatives' encompasses a wide range of financial products, and that not all of these products have the same structure as a repurchase or securities lending transaction. The above example of a currency swap, however, shows that there are types of derivatives that have a close connection with repurchase and securities lending arrangements. One could even go so far as to state that repos and securities lending arrangements are essentially types of derivatives. Repurchase and securities lending transactions are documented under separate master agreements but are structured in the same way as a currency swap.

A second reason to pay attention to derivatives is the International Swaps and Derivatives Association's (ISDA) credit support documents, which are used in connection with the ISDA's Master Agreements. As with repurchase and securities lending transactions, in the case of derivatives transactions it can also be agreed that margin collateral in the form of cash or securities should be provided to eliminate a net exposure arising from price fluctuations in the course of a transaction. In the case of derivatives, such an agreement is usually documented in a credit support document. Even though older credit support documents, such as the 1994 ISDA Credit Support Annex (New York law) and the 1995 ISDA credit support documentation (designed for English law), are still widely applied in practice, the focus hereafter will be on the ISDA May 2001 Margin Provisions, as this is the most recent credit support documentation. The version of the ISDA Margin Provisions designed for use in the New York market is highlighted below, because this is the primary example of a standardized agreement which applies a security interest combined with a secured party's general right of disposal as a way to provide financial collateral.

2.3 Title transfer or security interest

There are basically two methods of providing financial collateral: the first is by means of a 'title' or 'outright' transfer¹⁰, and the second, by establishing a security interest. Both methods are illustrated in the standard documentation used to document repurchase, securities lending and derivatives transactions. The title transfer method, for example, is used in the Global Master Repurchase Agreement (GMRA) for repos, the Global Master Securities Lending Agreement (GMSLA) for securities lending and, if English law applies, the ISDA Margin Provisions for derivatives.

10 For an elaboration of the terminology applied, see section 1.2 of chapter III.

According to this method, the parties deliberately opt for an outright transfer of collateral because they want to give the collateral taker an unlimited right to dispose of the collateral. If a security interest were to be established, the collateral taker customarily has a right to dispose of the collateral only in the event of default. For this reason, Section 3.1 of Part 3 ('Elective Provisions – Title Transfer Approach (English Law)') of the ISDA Margin Provisions designed for English law makes a clear distinction between these two methods:

Section 3.1 Transfer of Title and No Security Interest

- (a) **Transfer of Title** Each party agrees that all right, title and interest in and to any Lock-up Margin, Eligible Margin, Equivalent Margin, Substitute Margin, Equivalent Distributions or Interest Amount which it Transfers to the other party under these Provisions will vest in the recipient free and clear of any liens, claims, charges or encumbrances or any other interest of the Transferring party or of any third person (other than a lien routinely imposed on all securities in a relevant clearance system) Each Transfer under these Provisions will be made so as to constitute or result in a valid and legally effective transfer of the Transferring party's legal and beneficial title to the recipient
- (b) **No Security Interest** The parties do not intend to create in favour of either party any mortgage, charge, lien, pledge, encumbrance or other security interest in any Cash or other property, to which this Part 3 applies, Transferred by one party under these Provisions.

In the American derivatives and securities lending markets, however, financial collateral is often provided by vesting a security interest. The security interest approach is adopted in Part 2 ('Elective Provisions – Security Interest Approach (New York Law)') of the ISDA Margin Provisions in those cases where New York law is applicable, as well as in American domestic securities lending documentation. The security interest is, in these instances, combined with a 'right of use' for the collateral taker, which means that the collateral taker is given an unlimited right of disposal in respect of the collateral provided, even if no event of default has occurred. This means that he can, for example, repledge or sell the collateral as he deems fit.

2.4 Two functions of financial collateral

2.4.1 Recovery and tradeability

From an economic point of view, the securities and cash transferred in the repo, securities lending and derivatives transactions outlined above fulfil two functions. They can be used for the purposes of recourse if anything goes wrong in the relationship between the parties (thus serving a

recovery function). In addition, they can be used as a means of entering into further trading in the market (thus serving a tradeability function). It is because of this latter function that repos and securities lending arrangements play an important role in the liquidity of the international capital markets.¹¹ The tradeability function enhances liquidity. If a well-functioning repo and securities lending market is in place, cash and securities are readily available. It is this that makes the Collateral Directive (see section 8 below) so important, as its drafters intended that through harmonising rules throughout Europe, a liquid European cash and securities market could be achieved. Liquidity will not be enhanced if the cash or securities collateral provided cannot be used to enter into further trading. Like recovery, tradeability is therefore a characteristic feature of the financial products discussed in this book. The master agreements used for financial collateral agreements provide for recovery and tradeability when the title transfer and the security interest methods are used.

2.4.2 *The title transfer method*

In title transfer structures, both functions of recovery and tradeability are guaranteed. The collateral transferred serves as a security object in the event that anything should go wrong. Moreover, the transferee is also allowed to dispose of the collateral received under 'normal' circumstances, because the transferor has transferred all right, title and interest. The transferee has a contractual obligation to provide equivalent assets only at the end of the transaction.

In the United States of America, the country in which most of the financial products discussed first appeared, it has been argued that both tradeability and recovery are characteristic features of financial collateral arrangements. In her analysis of repurchase agreements under American civil law, J.L. Schroeder points out that there is an essential difference between repo transactions and traditional security interests. Both types of transactions serve a recovery function and can also be compared in other

11 On the liquidity-enhancing role of financial collateral, see CPB 2001, chapter 7. See also the letter dated 30 May 2001 by The Bond Market Association (joined by the European Repo Council) relating to the New Basel Capital Accord, which is enlightening in this respect. For more general information about the role of repurchase and securities lending agreements in the international financial markets, see BIS 1996, Appendix 2 ('Repos and the international financial markets'); BIS 1999; IOSCO 1999; BIS 2001 I; and BIS 2001 II.

respects. However, according to Schroeder, repurchase agreements can be distinguished from traditional security interests in that repurchase agreements give the collateral taker an unlimited power to dispose of the assets that have been provided. For this reason, these assets are customarily provided on the basis of an outright sale.¹²

2.4.3 *The security interest method*

Over the past decades, a second method to provide financial collateral has been developed in the American derivatives and securities lending markets. This method is the combination of a security interest with a general right of disposal for the collateral taker. The right of disposal distinguishes collateralised derivatives and securities lending transactions from traditional security interests. Under traditional security interest structures, only the recovery function of collateral is self-evident. In this case, the collateral taker has a right to dispose of the encumbered collateral only in the case of default. In order to enhance the tradeability of the collateral provided in derivatives and securities lending transactions, the collateral taker is, however, also granted a general right of disposal, the so-called 'right of use'.¹³

The ISDA Margin Provisions (New York law) are the principle example of a master agreement that envisages such a right of use. Section 2.2(c) of the 2001 ISDA Margin Provisions gives a secured party the right to 'sell, pledge, rehypothecate, assign, invest, use, commingle or otherwise dispose of, or otherwise use in its business, any Margin Received [...]'. A similar right of use was envisaged under New York law in Article 6(c) of the 1994 NY Annex, which is one of the earlier ISDA Credit Support Documents. The 1995 UK Deed, another of these Credit Support Documents, also envisaged the establishment of a security interest under English law, but prohibited a right of use in Article 6(d). The approach of the 2001 ISDA Margin Provisions in respect of English law is different from that of the 1995 UK Deed. The Margin Provisions only envisage the title transfer method under English law, and as such, guarantee tradeability. Whereas a security interest with a right of use therefore appears possible under New York law, this does not seem to be the case under general principles of English law.

12 See Schroeder 1996.

13 See Johnson 1997; Kettering 1999 I; Kettering 1999 II.

American domestic stock lending documentation also envisages a security interest combined with a right of use. In this case, however, it is subject to limitations in addition to those of the ISDA documentation. The right of use in the American derivatives and securities lending markets is discussed further in section 2 of chapter IV.

The Collateral Directive introduces a security interest combined with a general right of disposal in the European Union under the heading 'security financial collateral arrangement'. The consequences of this development are discussed further in chapter IV below. It is important to note that this construction encompasses both the recovery and the tradeability functions.

2.4.4 Terminology

The word 'collateral' has a 'security interest-related' meaning in the context of Anglo-American law. However, in both the title transfer and the security interest methods outlined above, financial collateral is available as an object for recovery, but may at the same time also be used to engage in further transactions. The collateral terminology, therefore, does not do full justice to the dual nature of the financial products discussed.¹⁴

Paragraph 6(f) of the GMRA and Paragraph 2.3 of the GMSLA contain explicit statements in respect of this discrepancy between terminology and intent. Paragraph 6(f) of the GMRA states:

Notwithstanding the use of expressions such as "Repurchase Date", "Repurchase Price", "margin", "Net Margin", "Margin Ratio" and "substitution", which are used to reflect terminology used in the market for transactions of the kind provided for in this Agreement, all right, title and interest in and to Securities and money transferred or paid under this Agreement shall pass to the transferee upon transfer or payment [...].

Paragraph 2.3 of the GMSLA states:

Notwithstanding the use of expressions such as "borrow", "lend", "Collateral", "Margin", "redeliver" etc. which are used to reflect terminology used in the market for transactions of the kind provided for in this Agreement, title to Securities "borrowed" or "lent" and "Collateral" provided in accordance with this Agreement shall pass from one Party to another as provided for in this Agreement [...].

14 For an elaboration of the misleading use of collateral terminology, see De Haas / Keijser 2001, pp. 6-7, and Keijser / De Haas 2001, p. 11.

These provisions make clear that the GMRA and the GMSLA actually intend a transfer of all right, title and interest, notwithstanding the terminology used in these agreements (such as the word 'collateral'), which only reflects the terms commonly used by market participants.

3. MASTER AGREEMENTS

3.1 Introduction

Associations representing the interests of the financial industry have developed master agreements for the documentation of repurchase and securities lending transactions. Qualitative legal documentation leads to an orderly market in which legal risks are transparent and limited as far as possible. Most repurchase and securities lending transactions are indeed entered into on the basis of the model contracts developed by these associations. Usually, the contracting parties enter into a master agreement once, and this agreement contains general provisions that apply to all transactions to be concluded. Subsequently, they enter into multiple transactions, each with its own specific terms (time frame, interest rates, etc.). Master agreements are not compulsory, but flexible instruments that can be adapted in accordance with the wishes of the contracting parties. This section shows the most important master agreements for the documentation of repurchase, securities lending and derivatives transactions, which are used in both an international and domestic context.

3.2 Repos

The most important master agreement used internationally to document repo transactions is the year 2000 version of the Global Master Repurchase Agreement (GMRA). This agreement was published by The Bond Market Association (TBMA) and by the International Securities Market Association (ISMA). TBMA is an American-based international trade association representing the interests of securities firms and banks active in the securities markets. TBMA was incorporated as the Public Securities Association in 1976, but changed its name to The Bond Market Association in 1997.¹⁵ The ISMA was founded in 1969 as the Association of International Bond Dealers, but changed its name to the International Securities Market Association in 1991. In July 2005, the ISMA merged with the

¹⁵ For more information about TBMA, see www.bondmarkets.com.

International Primary Market Association to form the International Capital Market Association (ICMA), a trade association representing the interests of players in the capital markets.¹⁶ Constituent bodies of the ICMA are the International Repo Council (IRC) and the European Repo Council (ERC), both of which represent the interests of participants in the repo markets.¹⁷

The structure of the GMRA is as follows. The GMRA master agreement sets out a number of general provisions that apply to all the transactions concluded under the terms of the master agreement. In order to further determine the content of the master agreement, the parties have to specify supplemental terms and conditions in Annex I to the GMRA. These supplemental terms and conditions apply to all transactions concluded between the parties. The specific content of individual transactions is determined in Annex II to the GMRA, which contains a Form of Confirmation. There are also a number of further Annexes to the GMRA, which deal with special types of securities (notably bills or equities), document agency or buy/sell back transactions, and which take into account legal issues in certain countries (such as Canada, Italy, Japan and the Netherlands). The most important substantive provisions of the GMRA are discussed in section 4 below, which relates to the flows of cash and securities in repo and securities lending transactions.

An earlier version of the GMRA was published in 1995 by the Public Securities Association (PSA; the predecessor of TBMA) and the ISMA. For an account of the differences between the 1995 and the 2000 versions, see the 'TBMA/ISMA Global Master Repurchase Agreement 2000 Version; Note of Principal Changes from the November 1995 Version'. The changes to the 1995 agreement are not discussed here, because they are largely of a technical nature. The basic structure of repo transactions, as described in section 4 below, is the same under the 1995 and the 2000 agreements. At present, the 1995 version is still used by a considerable number of market participants. An Amendment Agreement is, however, available to those parties who have entered into a GMRA 1995 and wish to use the

¹⁶ For more information about the ICMA, see www.icma-group.org.

¹⁷ Before the establishment of the IRC and ERC, the interests of repo market participants were represented in the repo sub-committee of the ISMA's council of reporting dealers. The IRC and ERC are governed by section 1000 ('Repo Dealers') of the ICMA's rules and recommendations, which form part of the ICMA Rule Book. More information on the IRC and ERC can be found on www.icma-group.org.

GMRA 2000 in order to document their repo business. Representative bodies of the financial industry, such as the European Repo Council, intend the GMRA 2000 to be the only agreement applied in the near future.¹⁸

There are also a number of standard agreements, which are used primarily in national markets. The TBMA Master Repurchase Agreement is principally used for repos in the American market, but can also be used for international transactions (see Annex III and Schedule III.A to the Agreement).¹⁹ The *Rahmenvertrag für echte Pensionsgeschäfte (Repos)* is used in the German repo market, and the *Convention-Cadre Relative aux Opérations de Pension Livrée* is used in documenting French repos.²⁰ In order to come to a more uniform European legal framework for documenting repos, the Master Agreement for Financial Transactions, commonly known as the European Master Agreement (EMA), is intended to replace the German and the French master agreements.²¹

3.3 Securities lending

At present, the master agreement that is the international market standard for entering into securities lending transactions is the Global Master Securities Lending Agreement (GMSLA). The GMSLA is issued by the International Securities Lenders Association (ISLA). The ISLA is a trade association established in 1989 to represent the common interests of the securities lending industry.²²

Before the introduction of the GMSLA, three agreements were applied. Each agreement was designed with a particular issuer of securities in mind. The Master Gilt Edged Stock Lending Agreement (MGESLA; in the market sometimes also referred to as GESLA) was used for gilts (government paper) issued by the British government. The Master Equity & Fixed Interest Stock Lending Agreement (MEFISLA) was used by British lenders for all kinds of other paper, such as equities or securities with a fixed interest rate issued by corporate entities. The Overseas Securities Lender's

18 For the GMRA materials, see www.icma-group.org and www.bondmarkets.com

19 For the TBMA Master Repurchase Agreement, see www.bondmarkets.com

20 For more information on the French master agreement, see Mouy / Nalbantian 1995 I, pp 17-18. See also Besse / Auckenthaler 1995

21 The EMA can be found on www.fbe.be. The EMA is discussed further in section 5 on cross-product arrangements

22 For more information, see www.isla.co.uk

Agreement (OSLA; December 1995 version) was used to document transactions by 'overseas' lenders involving all kinds of government and corporate paper.

The GMSLA is intended to replace the OSLA, the MEFISLA and the MGESLA. The GMSLA can be used for all types of securities. It is designed for international use. Provisions specific to the United Kingdom in the OSLA, MEFISLA and MGESLA have been omitted.²³ In practice, the OSLA is still applied by international market participants along with the GMSLA. The GMSLA consists of general provisions that apply to all transactions concluded under the agreement and of a Schedule, in which the parties specify the details of a particular transaction. Since the GMSLA is the most recent standard agreement, the most important provisions of the GMSLA are discussed in section 4 on the flows of cash and securities in securities lending and repo transactions.

In addition to international agreements, domestic securities lending agreements are also available. For the American market, TBMA and the American Securities Industry Association (SIA) have issued the Master Securities Loan Agreement (2000 version).²⁴ In Germany, for example, the *Rahmenvertrag für Wertpapierleihgeschäfte im Interbankenverkehr* and the *Rahmenvertrag für Wertpapierdarlehen* are available for entering into loans of securities²⁵, while in France the *Contrat cadre de prêts de titres*²⁶ is available. In Europe, it is now possible to enter into securities lending transactions under the European Master Agreement (EMA) which is intended to replace earlier domestic master agreements that were applied in a single jurisdiction, such as the German or French master agreements.²⁷

3.4 Derivatives

The standard agreements issued by the International Swaps and Derivatives Association (ISDA) are the most important agreements used

23 For the texts of the GMSLA, OSLA, MEFISLA and the MGESLA, see www.isla.co.uk

24 The TBMA/SIA documentation can be found on www.bondmarkets.com

25 The *Rahmenvertrag für Wertpapierdarlehen* is issued by the Federal Association of German Banks and is intended to replace the 1994 *Rahmenvertrag für Wertpapierleihgeschäfte im Interbankenverkehr*. See the Clifford Chance July/August 2000 Securities and Derivatives Newsletter

26 Issued by the *Association Française des Professionnels des Titres*

27 The EMA can be found on www.fbe.be. For more detailed information on the EMA, see section 5 on cross-product arrangements below

internationally for documenting derivatives transactions. The ISDA is the global trade association representing the derivatives industry; it was chartered in 1985.²⁸

The most recent basic agreement for entering into derivatives transactions issued by the ISDA is the 2002 Master Agreement, which succeeds the 1992 standard documentation. In practice, both the 2002 and the 1992 documentation are applied. Standard provisions that complement the 2002 and the 1992 basic documentation are available for the purposes of marking-to-market and margining in the course of a transaction. To this end, the 2002 Master Agreement can be complemented with the ISDA 2001 Margin Provisions. In addition to a more general section containing operational provisions, the ISDA Margin Provisions contain special, complementary sections relating to New York, English and Japanese law. The predecessors of the 2001 Margin Provisions are the earlier ISDA Credit Support Documents, such as the 1994 ISDA Credit Support Annex (New York law; security interest), the 1995 ISDA Credit Support Deed (English law; security interest), the 1995 ISDA Credit Support Annex (English law; transfer of title) and the ISDA Credit Support Annex (Japanese law). Both the 2001 Margin Provisions and the earlier Credit Support Documents are currently widely applied by market participants.

There are also domestic derivatives agreements, such as the German *Rahmenvertrag für Finanztermingeschäfte*, the French *Convention-cadre relative aux opérations de marché à terme*, and the Dutch *Raamovereenkomst Financiële Derivaten*²⁹. Since 2004, it has been possible to document over-the-counter³⁰ derivatives transactions under the European Master Agreement (EMA). The EMA is intended to provide a uniform European legal framework for documenting different types of financial transactions, and is discussed further in section 5 below.

28 For more information about the ISDA, see www.isda.org

29 This latter agreement has been commissioned by the *Nederlandse Vereniging van Banken* (the Netherlands Bankers' Association)

30 'Over-the-counter' derivatives transactions are derivatives transactions that are entered into in a market outside an officially recognized and regulated exchange

4. FLOWS OF CASH AND SECURITIES IN REPOS AND SECURITIES LENDING

4.1 Introduction

The aim of this section is to describe the different flows of cash and securities that take place in repurchase and securities lending transactions under normal circumstances as well as in the event of default. This topic can be sub-divided into further questions, which contribute to the structure of this section. It will be determined: (1) what flows of cash exist at the outset and at the termination of a transaction; (2) whether any methods of margin maintenance have been provided for; (3) whether substitution can take place; (4) what happens to interest, dividends and other income payments on transferred bonds or equities paid by the issuer; and last but not least, (5) in what circumstances interest rate payments take place in relation to flows of cash and securities in a transaction. These issues are considered in sections 4.2 – 4.6. In addition, the payment obligations arising in the event of default, such as insolvency, are considered in section 4.7.³¹

In short, the flows of cash and securities in repo and securities lending transactions under normal circumstances are as follows. At the outset of a *repo transaction* a seller receives cash from a buyer, to whom he transfers securities. At the end of the transaction, the seller transfers cash (consisting of a principal amount plus a sum calculated according to a rate of interest), in exchange for the transfer of equivalent securities. However, it is usually the case that payments also take place during the course of a transaction. First, the parties usually agree upon so-called 'margin maintenance' mechanisms in order to take into account changes in the value of the securities and cash transferred at an earlier moment in a transaction. Different methods of margin maintenance, described in more detail below, are used to ensure that neither of the parties is exposed to the other beyond such limits as have been agreed upon between them. Second, it is possible, if so agreed, to substitute securities transferred earlier in the transaction for other securities. Substitution is a way of recovering securities that were transferred earlier in the course of a transaction in exchange for other securities. Substitution may relate to securities provided at the outset of a transaction, or to margin securities that were transferred to compensate for price fluctuations. Third, the transferee of securities is

31 Payments related to any tax or duties imposed are not dealt with in this study.

usually under a contractual obligation to pay to the transferor of such securities amounts of income that are equal to that paid in the course of a transaction in respect of the securities transferred. In addition, cash collateral and payments due but not yet paid are, as a rule, subject to interest.

In a *securities lending transaction*, there is at the outset a flow of securities from the lender to the borrower, which is usually collateralised by a flow of cash or securities.³² Equivalent securities plus an amount calculated by applying an agreed rate of interest are delivered by the borrower to the lender at the end of a transaction, while a transfer of equivalent collateral is effected at the same time. As a rule, the parties to a securities lending agreement (like the parties to a repurchase agreement) envisage the following: margin maintenance methods to take price fluctuations into account, the possibility of substitution, the payment of amounts equivalent to income payments, and the accrual of interest in respect of cash collateral and payments due but not yet paid.

The issues introduced above, including the regime applicable in the event of default, will be explained in the context of repos and securities lending as documented in standard agreements used in the markets. For repos, the Global Master Repurchase Agreement (GMRA) will be used as an example; for securities lending, the Global Master Securities Lending Agreement (GMSLA) will be used.

4.2 Initial and final flows

4.2.1 Repos

Paragraph 1(a) of the GMRA provides a clear illustration of the principal flows of cash and securities that take place at the outset and at the end of a repo transaction:

From time to time the parties hereto may enter into transactions in which one party, acting through a Designated Office, ("Seller") agrees to sell to the other, acting through a Designated Office, ("Buyer") securities and financial instruments ("Securities") [...] against the payment of the purchase price by Buyer to Seller, with a simultaneous agreement by Buyer to sell to Seller Securities equivalent to such

32 In practice, uncollateralized transactions also occur. In this case, the lender has an unsecured exposure towards the borrower. Following the GMSLA, an agreement which presumes collateralisation, this section only deals with collateralised transactions.

Securities at a date certain or on demand against the payment of the repurchase price by Seller to Buyer

In a repo transaction, securities are transferred outright at moment T from party A (seller) to party B (buyer) in exchange for a sum of money. Paragraph 3(c) of the GMRA states:

On the Purchase Date for a Transaction, Seller shall transfer the Purchased Securities to Buyer or its agent against the payment of the Purchase Price by Buyer

The securities transferred at moment T are usually valued at market prices and a certain percentage is then discounted from this price. The *percentage* discounted from the market value of the securities is usually referred to as 'margin ratio' or 'haircut', while the resulting *amount* discounted on the basis of such percentage is called 'initial margin'. The effect of this initial margin is that the buyer (i.e. the party who provides the principal cash flow) is ensured a buffer against downward price fluctuations of the collateral provided from the outset of a transaction. This buffer is maintained during the entire course of the transaction.³³

The initial transfer at moment T is followed at moment T+X by a transfer of equivalent securities by buyer B to seller A, in exchange for a sum of money equal to that transferred at the outset of the transaction plus a price differential (the 'repurchase price'). Article 3(f) of the GMRA states:

On the Repurchase Date, Buyer shall transfer to Seller or its agent Equivalent Securities against the payment of the Repurchase Price by Seller (less any amount then payable and unpaid by Buyer to Seller pursuant to paragraph 5 [relating to income payments, TK])

The price differential, which is a component of the repurchase price, is essentially an *amount* of interest. The interest *percentage* is called the 'pricing rate' or 'repo rate'.³⁴

33 See Paragraphs 2(z) and 2(ww) of the GMRA. For more about this 'over-collateralisation', see also Rank 1998 I, p. 17, Rank 1998 II, p. 373.

34 See Paragraphs 2(ii) (definition of 'price differential') and 2(jj) (definition of 'pricing rate') of the GMRA.

4.2.2 *Securities lending*

Paragraph 1.1 of the GMSLA provides a good illustration of the principal flows of cash and securities that commonly take place at the outset and at the end of a securities lending transaction:

From time to time the parties may enter into transactions in which one party ("Lender") will transfer to the other ("Borrower") securities and financial instruments ("Securities") against the transfer of Collateral (as defined in paragraph 2) with a simultaneous agreement by Borrower to transfer to Lender Securities equivalent to such Securities on a fixed date or on demand against the transfer to Borrower by Lender of assets equivalent to such Collateral.

In a securities lending transaction, party A (the lender) typically transfers securities to party B (the borrower) at the beginning of a transaction against a simultaneous transfer of cash or securities from party B to party A as collateral.³⁵ Like the GMRA, the GMSLA also envisages an initial margin that protects the lender (i.e. the party delivering the principal performance) against downward price fluctuations from the outset of a transaction. This level of over-collateralisation of the lender is a way to protect the lender against the possible insolvency of his counterparty and is maintained during the entire course of a transaction.³⁶ At the end of the transaction, borrower B transfers equivalent securities to lender A, and in addition pays an amount of interest³⁷, which is also called the 'lending fee'. At that moment, A is obliged to transfer collateral equivalent to that provided by party B at the start of the transaction.

4.3 **Margin maintenance**

4.3.1 *Introduction*

Both the GMRA and the GMSLA set out margin maintenance methods that take price fluctuations of transferred securities into account. These methods basically have the same goal: to prevent one of the parties from being exposed to a risk in relation to the other as a result of an increase or decrease in the value of the securities and/or cash transferred in transactions. All margin maintenance methods have in common that the transferor of securities or cash economically carries the risk of such price

35 Uncollateralized transactions (in line with the structure of the GMSLA) will not be discussed. Cf. footnote 32.

36 See section 1.2 of the Schedule to the GMSLA.

37 See Paragraph 7.1 of the GMSLA.

fluctuations. This section describes the different margin maintenance methods set out in the GMRA and the GMSLA.³⁸

4.3.2 *Repos*

Three different methods of margin maintenance can be distinguished under the GMRA: (1) margin transfers; (2) repricing; and (3) adjustment. These methods will now be considered in more detail.

a Margin transfers

The most common way of taking into account changes in the value of securities and cash transferred is by realising *margin transfers*, as described in Paragraphs 4 (a) – (h) of the GMRA. The text of these provisions is as follows:

4 Margin Maintenance

(a) If at any time either party has a Net Exposure in respect of the other party it may by notice to the other party require the other party to make a Margin Transfer to it of an aggregate amount or value at least equal to that Net Exposure

(b) A notice under sub-paragraph (a) above may be given orally or in writing

(c) For the purposes of this Agreement a party has a Net Exposure in respect of the other party if the aggregate of all the first party's Transaction Exposures plus any amount payable to the first party under paragraph 5 [relating to income payments, TK] but unpaid less the amount of any Net Margin provided to the first party exceeds the aggregate of all the other party's Transaction Exposures plus any amount payable to the other party under paragraph 5 but unpaid less the amount of any Net Margin provided to the other party, and the amount of the Net Exposure is the amount of the excess. For this purpose any amounts not denominated in the Base Currency shall be converted into the Base Currency at the Spot Rate prevailing at the relevant time

(d) To the extent that a party calling for a Margin Transfer has previously paid Cash Margin which has not been repaid or delivered Margin Securities in respect of which Equivalent Margin Securities have not been delivered to it, that party shall be entitled to require that such Margin Transfer be satisfied first by the repayment of such Cash Margin or the delivery of Equivalent Margin Securities but, subject to this, the composition of a Margin Transfer shall be at the option of the party making such Margin Transfer

(e) Any Cash Margin transferred shall be in the Base Currency or such other currency as the parties may agree

(f) A payment of Cash Margin shall give rise to a debt owing from the party receiving such payment to the party making such payment. Such debt shall bear interest at such rate, payable at such times, as may be specified in Annex I hereto

38 The legal characterisation of these methods will be further discussed in section 2.6 of chapter III

in respect of the relevant currency or otherwise agreed between the parties, and shall be repayable subject to the terms of this Agreement.

(g) Where Seller or Buyer becomes obliged under sub-paragraph (a) above to make a Margin Transfer, it shall transfer Cash Margin or Margin Securities or Equivalent Margin Securities within the minimum period specified in Annex I hereto or, if no period is there specified, such minimum period as is customarily required for the settlement or delivery of money, Margin Securities or Equivalent Margin Securities of the relevant kind

(h) The parties may agree that, with respect to any Transaction, the provisions of subparagraphs (a) to (g) above shall not apply but instead that margin may be provided separately in respect of that Transaction in which case -

- (i) that Transaction shall not be taken into account when calculating whether either party has a Net Exposure,
- (ii) margin shall be provided in respect of that Transaction in such manner as the parties may agree, and
- (iii) margin provided in respect of that Transaction shall not be taken into account for the purposes of sub-paragraphs (a) to (g) above

Subsequent to these provisions, the buyer is obliged to deliver margin in the form of cash or securities to the seller if the prices of securities transferred by the seller at the outset of a transaction have increased. If the prices have decreased, the seller is obliged to provide margin in the form of cash or securities to the buyer. Price fluctuations in respect of margin securities provided earlier in the course of a transaction are taken into account in the same way. Margin transfers are usually made on the basis of a net exposure, as calculated on the basis of all the transactions entered into by the parties to a GMRA. The determination of obligations to provide margin on the basis of all outstanding transactions is sometimes referred to as 'global margining'. The exact way the net exposure is calculated is described in Paragraphs 4 (a) – (g) of the GMRA. However, it is also possible to make margin transfers per transaction. This possibility has been provided for in subparagraph (h). Margin can be provided in the form of securities or cash. The parties to a GMRA usually agree beforehand what they consider to be 'eligible' collateral. The party who is under an obligation to transfer margin usually determines exactly what eligible collateral will be transferred, unless he has received margin cash or securities from his counterparty at an earlier moment in the transaction. In this case, the counterparty may first require the payment of equivalent cash or securities.

At the end of a transaction, equivalent margin must be transferred by the transferee of margin to the transferor. This is illustrated in the following example. Seller A receives 100 euro from buyer B for 100 securities of type

X with a total value of 100 euro.³⁹ Because the total value of the securities X drops to 90 euro in the course of the transaction, seller A transfers 10 margin securities of type Y to buyer B with a total value of 10 euro. At the end of the transaction, seller A is obliged to pay 100 euro to buyer B, whereas buyer B is under an obligation to transfer both 100 securities of type X with a total value of 90 euro and 10 securities of type Y with a total value of 10 euro. The payment of equivalent margin at the end of the transaction ensures that the parties are in an economically equal position again.

b. Repricing and adjustment

Margin transfers are not the most appropriate method in the case of extreme changes in value. It is, of course, possible to realise margin transfers in such situations, but the ultimate result will be that the value of margin transferred by one of the parties is disproportionately high compared to the value of the securities and cash originally provided. This is why two other methods have been introduced, i.e. repricing and adjustment. See Paragraphs 4 (i) – (k) of the GMRA:

(i) The parties may agree that any Net Exposure which may arise shall be eliminated not by Margin Transfers under the preceding provisions of this paragraph but by the repricing of Transactions under sub-paragraph (j) below, the adjustment of Transactions under sub-paragraph (k) below or a combination of both these methods

(j) Where the parties agree that a Transaction is to be repriced under this sub-paragraph, such repricing shall be effected as follows -

(i) the Repurchase Date under the relevant Transaction (the "Original Transaction") shall be deemed to occur on the date on which the repricing is to be effected (the "Repricing Date"),

(ii) the parties shall be deemed to have entered into a new Transaction (the "Repriced Transaction") on the terms set out in (iii) to (vi) below,

(iii) the Purchased Securities under the Repriced Transaction shall be Securities equivalent to the Purchased Securities under the Original Transaction,

(iv) the Purchase Date under the Repriced Transaction shall be the Repricing Date,

(v) the Purchase Price under the Repriced Transaction shall be such amount as shall, when multiplied by the Margin Ratio applicable to the Original Transaction, be equal to the Market Value of such Securities on the Repricing Date,

(vi) the Repurchase Date, the Pricing Rate, the Margin Ratio and, subject as aforesaid, the other terms of the Repriced Transaction shall be identical to those of the Original Transaction,

39 No margin ratio is applied in this example

(vii) the obligations of the parties with respect to the delivery of the Purchased Securities and the payment of the Purchase Price under the Repriced Transaction shall be set off against their obligations with respect to the delivery of Equivalent Securities and payment of the Repurchase Price under the Original Transaction and accordingly only a net cash sum shall be paid by one party to the other. Such net cash sum shall be paid within the period specified in sub-paragraph (g) above

(k) The adjustment of a Transaction (the "Original Transaction") under this sub-paragraph shall be effected by the parties agreeing that on the date on which the adjustment is to be made (the "Adjustment Date") the Original Transaction shall be terminated and they shall enter into a new Transaction (the "Replacement Transaction") in accordance with the following provisions -

(i) the Original Transaction shall be terminated on the Adjustment Date on such terms as the parties shall agree on or before the Adjustment Date,

(ii) the Purchased Securities under the Replacement Transaction shall be such Securities as the parties shall agree on or before the Adjustment Date (being Securities the aggregate Market Value of which at the Adjustment Date is substantially equal to the Repurchase Price under the Original Transaction at the Adjustment Date multiplied by the Margin Ratio applicable to the Original Transaction),

(iii) the Purchase Date under the Replacement Transaction shall be the Adjustment Date,

(iv) the other terms of the Replacement Transaction shall be such as the parties shall agree on or before the Adjustment Date, and

(v) the obligations of the parties with respect to payment and delivery of Securities on the Adjustment Date under the Original Transaction and the Replacement Transaction shall be settled in accordance with paragraph 6 within the minimum period specified in sub-paragraph (g) above

In the case of *repricing*, the original transaction is terminated, and a new transaction is entered into. The idea is that the original securities are maintained, but their price is adjusted to the actual prices in the market. Thus, if the market prices of securities transferred under the original transaction have gone up, the cash to be provided under the new transaction will be higher, whereas if the market prices of the transferred securities have gone down since the moment the original transaction was entered into, the amount of cash to be provided will be lower than in the original transaction.

In the case of an *adjustment*, the parties elect to alter the securities side of a transaction and not the cash side as is the case with repricing. In this instance, although the original transaction is also terminated and a new transaction is entered into, the parties agree on a different kind or amount of securities as a means of credit risk mitigation. These securities will be transferred at market value at the outset of the new transaction, taking into account the margin ratio or 'haircut', as agreed between the parties.

4.3.3 Securities lending

Securities lending agreements usually contain margin maintenance provisions that are comparable to the margin transfer method under the GMRA.⁴⁰ In the GMSLA, Paragraphs 5.4 and 5.5 address this matter:

5 4 Marking to Market of Collateral during the currency of a Loan on aggregated basis

Unless paragraph 1 3 of the Schedule indicates that paragraph 5 5 shall apply in lieu of this paragraph 5 4, or unless otherwise agreed between the Parties -

(i) the aggregate Market Value of the Collateral delivered to or deposited with Lender (excluding any Equivalent Collateral repaid or redelivered under Paragraphs 5 4(ii) or 5 5(ii) (as the case may be)) ("Posted Collateral") in respect of all Loans outstanding under this Agreement shall equal the aggregate of the Market Value of the Loaned Securities and the applicable Margin (the "Required Collateral Value") in respect of such Loans,

(ii) if at any time on any Business Day the aggregate Market Value of the Posted Collateral in respect of all Loans outstanding under this Agreement exceeds the aggregate of the Required Collateral Values in respect of such Loans, Lender shall (on demand) repay and/or redeliver, as the case may be, to Borrower such Equivalent Collateral as will eliminate the excess,

(iii) if at any time on any Business Day the aggregate Market Value of the Posted Collateral in respect of all Loans outstanding under this Agreement falls below the aggregate of Required Collateral Values in respect of all such Loans, Borrower shall (on demand) provide such further Collateral to Lender as will eliminate the deficiency

5 5 Marking to Market of Collateral during the currency of a Loan on a Loan by Loan basis

If paragraph 1 3 of the Schedule indicates this paragraph 5 5 shall apply in lieu of paragraph 5 4, the Posted Collateral in respect of any Loan shall bear from day to day and at any time the same proportion to the Market Value of the Loaned Securities as the Posted Collateral bore at the commencement of such Loan Accordingly

(i) the Market Value of the Posted Collateral to be delivered or deposited while the Loan continues shall be equal to the Required Collateral Value,

(ii) if at any time on any Business Day the Market Value of the Posted Collateral in respect of any Loan exceeds the Required Collateral Value in respect of such Loan, Lender shall (on demand) repay and/or redeliver, as the case may be, to Borrower such Equivalent Collateral as will eliminate the excess, and

(iii) if at any time on any Business Day the Market Value of the Posted Collateral falls below the Required Collateral Value, Borrower shall (on demand) provide such further Collateral to Lender as will eliminate the deficiency

If there is a discrepancy between the value of the lent securities and the collateral provided (taking the margin haircut into account), one of the parties will be obliged to make a margin transfer. If the value of the

40 Repricing and adjustment are not envisaged under the GMSLA

collateral has become higher than the value of the securities lent, the lender is obliged to transfer equivalent collateral. The borrower must transfer additional collateral if the loaned securities have become more valuable than the collateral provided to the lender. The determination of the market value of the loaned securities and the collateral securities provided is usually called 'marking to market'. Under the GMSLA, marking to market of collateral is possible both on an aggregated basis (see Paragraph 5.4), as well as on a loan by loan basis, i.e. per transaction (see Paragraph 5.5). As in the case of a margin transfer under a repurchase transaction, the transferee of margin collateral in a securities lending transaction is obliged to transfer equivalent margin collateral to the transferor of that margin collateral at the end of the transaction they entered into.⁴¹

4.4 Substitution

If substitution has been agreed upon, the transferor of purchased or margin securities under a repo transaction may substitute the securities originally transferred for other acceptable securities. In a securities lending transaction, too, the transferor of collateral or margin collateral securities can call for substitution.⁴² For repos, substitution has been set out in Paragraph 8 of the GMRA.

8 Substitution

(a) A Transaction may at any time between the Purchase Date and Repurchase Date, if Seller so requests and Buyer so agrees, be varied by the transfer by Buyer to Seller of Securities equivalent to the Purchased Securities, or to such of the Purchased Securities as shall be agreed, in exchange for the transfer by Seller to Buyer of other Securities of such amount and description as shall be agreed ("New Purchased Securities") (being Securities having a Market Value at the date of the variation at least equal to the Market Value of the Equivalent Securities transferred to Seller)

(b) Any variation under sub-paragraph (a) above shall be effected, subject to paragraph 6(d) [relating to payment and transfer, TK], by the simultaneous transfer of the Equivalent Securities and New Purchased Securities concerned.

(c) A Transaction which is varied under sub-paragraph (a) above shall thereafter continue in effect as though the Purchased Securities under that Transaction consisted of or included the New Purchased Securities instead of the Securities in respect of which Equivalent Securities have been transferred to Seller

(d) Where either party has transferred Margin Securities to the other party it may at any time before Equivalent Margin Securities are transferred to it under

41 See Paragraph 8 4 of the GMSLA

42 In the context of securities lending, it should be noted that loaned securities cannot be substituted (because this is the principal flow, see section 2 2 2 above) and that substitution is only possible in relation to collateral and margin collateral provided

paragraph 4 [relating to margin maintenance, TK] request the other party to transfer Equivalent Margin Securities to it in exchange for the transfer to the other party of new Margin Securities having a Market Value at the time of transfer at least equal to that of such Equivalent Margin Securities. If the other party agrees to the request, the exchange shall be effected, subject to paragraph 6(d) [relating to payment and transfers, TK], by the simultaneous transfer of the Equivalent Margin Securities and new Margin Securities concerned []

In the case of a securities lending transaction, Paragraph 5.3 of the GMSLA determines the situations in which substitution can take place.⁴³

5.3 Substitutions of Collateral

Borrower may from time to time call for the repayment of Cash Collateral or the redelivery of Collateral equivalent to any Collateral delivered to Lender prior to the date on which the same would otherwise have been repayable or redeliverable provided that at the time of such repayment or redelivery Borrower shall have delivered or delivers Alternative Collateral acceptable to Lender and Borrower is in compliance with paragraph 5.4 or paragraph 5.5 [relating to marking to market, TK], as applicable

The rationale behind substitution is different from that behind adjustment. Adjustment is a margin maintenance method, which takes into account changes in the market value of the securities originally transferred by replacing those securities. Substitution, in turn, reflects the desire of the transferor of securities to have the securities originally transferred returned and used for other purposes, while in exchange he transfers other securities as a substitute. Substitution can take place with the consent of the transferee of financial collateral. Such consent can be given beforehand (in the Form of Confirmation to a GMRA or the Schedule to a GMSLA), or in the course of a transaction.⁴⁴

4.5 Income payments

After the transfer of securities by a transferor to a transferee in a repurchase or securities lending transaction, income payments in respect of such securities are payable to the transferee. Income payments are, for example, interest, dividends or other earnings of any kind on the secu-

⁴³ Paragraph 5.9 of the GMSLA contains a specific regulation for the substitution of letters of credit

⁴⁴ The legal interpretation of substitution is the topic of section 2.7 of chapter III. For substitution arrangements in the context of derivatives transactions, see Section 1.7 of the 2001 ISDA Margin Provisions. The earlier ISDA Credit Support Documents also envisage a right of substitution. See the 1994 NY Annex, Article 4(d), the 1995 UK Deed, Article 4(d), and the 1995 UK Annex, Article 3(c)

rities transferred. As a rule, an amount equal to such income payments is subsequently transferred by the transferee of such securities to the transferor. Such a method has been set out for repos in Paragraph 5 of the GMRA.

5 Income Payments

Unless otherwise agreed -

- (i) where the Term of a particular Transaction extends over an Income Payment Date in respect of any Securities subject to that Transaction, Buyer shall on the date such Income is paid by the issuer transfer to or credit to the account of Seller an amount equal to (and in the same currency as) the amount paid by the issuer,
- (ii) where Margin Securities are transferred from one party ("the first party") to the other party ("the second party") and an Income Payment Date in respect of such Securities occurs before Equivalent Margin Securities are transferred by the second party to the first party, the second party shall on the date such Income is paid by the issuer transfer to or credit to the account of the first party an amount equal to (and in the same currency as) the amount paid by the issuer []

In the case of securities lending transactions, Paragraphs 6.1, 6.2 and 4.4 of the GMSLA should be considered. Paragraph 6.1 relates to income payments generally, which are often made in the form of cash. Paragraph 6.2 of the GMSLA relates to the special case of income provided in the form of securities. Paragraph 4.4 of the GMSLA is included in Paragraph 4 on 'Delivery' and contains a technical description of the way that equivalent income should be made available.

6.1 Manufactured Payments

Where Income is paid in relation to any Loaned Securities or Collateral (other than Cash Collateral) on or by reference to an Income Payment Date Borrower, in the case of Loaned Securities, and Lender, in the case of Collateral, shall, on the date of the payment of such Income, or on such other date as the Parties may from time to time agree, (the "Relevant Payment Date") pay and deliver a sum of money or property equivalent to the type and amount of such Income that, in the case of Loaned Securities, Lender would have been entitled to receive had such Securities not been loaned to Borrower and had been retained by Lender on the Income Payment Date, and, in the case of Collateral, Borrower would have been entitled to receive had such Collateral not been provided to Lender and had been retained by Borrower on the Income Payment Date unless a different sum is agreed between the Parties

6.2 Income in the form of Securities

Where Income, in the form of securities, is paid in relation to any Loaned Securities or Collateral, such securities shall be added to such Loaned Securities or Collateral (and shall constitute Loaned Securities or Collateral, as the case may be, and be part of the relevant Loan) and will not be delivered to Lender, in the case of Loaned Securities, or to Borrower, in the case of Collateral, until the end of the relevant Loan, provided that the Lender or Borrower (as the case may be) fulfils their

obligations under paragraph 5 4 or 5 5 (as applicable) [relating to marking to market, TK] with respect to the additional Loaned Securities or Collateral, as the case may be

4 4 Deliveries of Income

In respect of Income being paid in relation to any Loaned Securities or Collateral, Borrower in the case of Income being paid in respect of Loaned Securities and Lender in the case of Income being paid in respect of Collateral shall provide to the other Party, as the case may be, any endorsements or assignments as shall be customary and appropriate to effect the delivery of money or property equivalent to the type and amount of such Income to Lender, irrespective of whether Borrower received the same in respect of any Loaned Securities or to Borrower, irrespective of whether Lender received the same in respect of any Collateral

A regulation such as that contained in the GMRA and the GMSLA provides the best way of compensating the transferor of the securities for income payments, as it may be difficult to provide for such compensation in advance, particularly when the amount of dividend that will be distributed cannot be established in advance or in transactions with an unspecified duration.

4.6 Interest

4.6.1 *Price differential and lending fee*

The payment of the price differential for repos and the lending fee in securities lending as discussed in section 4.2 above may be considered as a payment of interest. In a repo transaction, this interest is paid by the seller in respect of the cash provided by the buyer at the outset of the transaction. In a securities lending transaction, the borrower pays an amount of interest for the securities provided by the lender at the outset of the transaction. The price differential in the case of a repo transaction is payable on the repurchase date.⁴⁵ The lending fee accrues until the date when equivalent securities are redelivered.⁴⁶

4.6.2 *Cash collateral*

In addition, the GMRA and the GMSLA also contain provisions relating to the payment of interest when cash collateral is provided. In repo transactions, cash collateral can only be paid in the course of a transaction in the form of margin. The GMRA contains a provision for a rate payable in

45 See Paragraphs 2 (ii) and (jj) of the GMRA

46 See Paragraphs 7 1 and 7 3 of the GMSLA

respect of cash margin in Paragraph 4(f), a provision already quoted in section 4.3.2 above. In the case of securities lending transactions, cash collateral can be provided both at the outset of a transaction by the borrower and in the course of the transaction by either party. In respect of such cash collateral the GMSLA also determines that an interest rate should be paid, which accrues until the date of the repayment of the cash collateral (see Paragraphs 7.2 and 7.3 of the GMSLA).

4.6.3 Interest on other sums due

Other interest payments may also take place. Paragraph 12 of the GMRA sets out a general provision for the payment of interest on sums due, but not yet paid. The applicable interest rate is the greater of either the repo rate under the relevant transaction (if it is possible to relate a sum to a transaction) or LIBOR. Paragraph 15, in conjunction with Paragraph 10.7 of the GMSLA, provides a comparable provision for outstanding payments in securities lending transactions.

4.7 Events of default

Paragraph 10 of the GMRA sets out the regime which is applicable in the event of a default that leads to the termination of a single transaction or to that of the relationship between the parties as such.⁴⁷ Paragraph 10(a) of the GMRA specifies the different events of default that can arise, such as non-compliance with specified contractual obligations or the insolvency of one of the parties. Under Paragraph 10 of the GMRA an event which amounts to default in principle results in the early termination of all outstanding transactions between the parties. However, in certain circumstances a single transaction only may be terminated.⁴⁸ Early termination takes place automatically when certain events of insolvency occur, but in most cases, prior notice is required. Essentially, early termination means that all payment obligations the parties have towards each other are accelerated. Delivery obligations of equivalent securities, including equivalent margin securities, and all other applicable obligations, are converted into cash sums payable on the basis of market value. Subsequently, all cash sums due are converted into a single 'base' currency, if necessary. A set-off is then applied to all resulting cash obligations

47 Because of its length, the text of Article 10 of the GMRA is not reproduced here.

48 See Paragraphs 10(g)(iii) and 10(h)(iii) of the GMRA.

of the parties. The result is that one of the parties is obliged to pay a net sum to the other party.⁴⁹

The issue of valuation of securities (including equivalent securities), which is addressed in Paragraphs 10(e) and (f) of the GMRA, is crucial, and plays a role in the analysis in chapter V below. In fact, the non-defaulting party may, within the limits of Paragraph 10, determine how valuation will take place. He has three options, one of which should be exercised within a period of five dealing days. These options are outlined below; a more precise description can be found in the text of the GMRA. First, the non-defaulting party can sell securities that he should normally have delivered to the defaulting party and/or buy securities that he normally would have received from the defaulting party. In this case, his valuation is based on actual market prices received or paid. Second, he can obtain price quotes from two or more market makers or regular dealers in the most appropriate market for the securities concerned. Third, under certain circumstances he is allowed to determine a commercially reasonable price for the securities himself.

Similar provisions are set out in Paragraphs 9, 10 and 14 of the GMSLA for securities lending arrangements. Paragraph 14 of the GMSLA sets out the different events of default that may occur. Paragraph 10 of the GMSLA determines what happens when an event of default occurs. Basically, this again boils down to an early termination of all outstanding rights and obligations that are valued and converted into a single currency (if necessary), after which set-off takes place. The result is again a single amount payable by one of the parties. As a rule, an event of default leads to a close-out of all outstanding transactions between the parties. See, however, Paragraph 9 of the GMSLA for the possibility of a mini-close-out of individual transactions.⁵⁰

In the case of the GMSLA, valuation can take place on the basis of the actual sale price or cost of a buy-in. This sale or buy-in should take place within a period of five business days.⁵¹ If no actual sale or buy-in takes place, the prices of securities should be commercially reasonable, and

49 In addition to the text of Paragraph 10 of the GMRA, see also the relevant Guidance Notes.

50 Because of their length, Paragraphs 9, 10 and 14 of the GMSLA are not reproduced here.

51 See Paragraph 10.5 of the GMSLA.

should be established within two business days at most.⁵² Unlike the GMRA, the GMSLA contains no explicit reference to market makers or regular dealers as a means of objectively determining a reasonable price.

5. CROSS-PRODUCT ARRANGEMENTS

5.1 Introduction

Cross-product arrangements are entered into between parties who conclude different types of financial agreements and transactions. Cross-product arrangements make it possible to link flows of cash and securities in different types of financial products. If, for example, two parties have both entered into repurchase and securities lending agreements and transactions, they may wish to link the flows of cash and securities under these arrangements. Under 'normal' circumstances, they may wish to net payment obligations arising, whereas it may also be attractive to determine margin requirements on a consolidated basis. In the case of an event of default, the parties may wish to terminate both their repurchase and their securities lending agreements at the same time and pay only a single net sum after close-out netting of all outstanding repurchase and securities lending transactions.

This section explores different ways in which flows of cash and securities in different financial products can be linked to one another through cross-product arrangements. It is possible to distinguish at least three means of connecting different financial agreements in such a way that mutual obligations between the parties arising under those agreements can be netted. First, flows of cash and securities under different agreements can be connected by including a clause in one or more agreements that refers to the other agreement(s) involved. This way of linking agreements is usually referred to as the 'bridge provision' approach. The second possibility is to document different financial products in a single master agreement. A third approach is that of the 'master master' agreement. In this case, the parties conclude several master agreements to document different financial transactions. In addition, they conclude a 'master master' agreement that makes it possible to link the flows of cash and securities under the

52 See the definitions of 'Bid Value' and 'Offer Value' in Paragraph 10.1 of the GMSLA, and Paragraphs 10.3 and 10.4 of the GMSLA.

respective master agreements for different financial products. These three possibilities are discussed in sections 5.2, 5.3 and 5.4 below.

Over the past ten years, several legal initiatives have been developed, such as the ISDA Cross-Agreement Bridge, the European Master Agreement (EMA) and the Cross-Product Master Agreement (CPMA) to be discussed below, which demonstrate the growing importance of cross-product arrangements in the financial markets. Some remarks about the practical application of these different agreements, which to a large extent have the same goal, are made in section 5.5.

5.2 Bridge provisions

5.2.1 Introduction

One way to link flows of cash and securities under different financial agreements is to include a bridge provision in one or more agreements, which refers to the other agreement(s) involved. Different types of bridge provisions can be envisaged. One type would make it possible to net payment obligations under 'normal' circumstances. Such a provision seems to be of particular importance in linking cash flows in different financial products. Securities flows can consist of so many different types of securities that under normal circumstances, the netting of securities flows will often be of less importance. A second type of bridge provision limits the scope of such provisions to default situations, so that set-off of mutual obligations (which occurs after determining the monetary value of securities and converting cash obligations into a single currency) under different financial products takes place only in that event.

5.2.2 ISDA Cross-Agreement Bridge

The 2001 ISDA Cross-Agreement Bridge is an example of a bridge provision that operates in the event of a default. This Cross-Agreement Bridge is incorporated into an ISDA Master Agreement and is intended to achieve cross-product netting between the ISDA Master Agreement and other financial master agreements, such as repurchase or securities lending master agreements. In the Cross-Product Bridge, the parties specify the events ('bridging events') that lead to a close-out under all the master agreements indicated in the Cross-Product Bridge ('bridged agreements'). When a bridging event occurs, all bridged agreements are closed-out according to the provisions of those agreements. This means that no

uniform close-out netting procedure is envisaged in the ISDA Cross-Agreements Bridge. The procedures set out in the individual bridged agreements are left intact. The close-out netting of each bridged agreement leads to a payment obligation for one of the parties. All individual payment obligations under the bridged agreements involved are subsequently netted in accordance with the Cross-Agreement Bridge. The result of the netting of the different close-out netting amounts due is that a single net sum is payable by one of the parties.⁵³

5.3 Single master agreement for multiple financial products

5.3.1 Introduction

A second way in which to link different financial products is by documenting them in a single master agreement. A good example of such an approach can be found in the Master Agreements of the International Swaps and Derivatives Association (ISDA), under which a large variety of derivatives products can be documented. Another example is the European Master Agreement (EMA), under which repos, securities lending and derivatives transactions can be entered into. The European Master Agreement and its cross-product character in particular, is examined below.

5.3.2 European Master Agreement

The European Master Agreement (EMA) is officially called the Master Agreement for Financial Transactions. The EMA was launched by the European Banking Federation in co-operation with the European Savings Banks Group and the European Association of Co-operative Banks. The EMA is intended to establish a uniform legal framework for the documentation of repurchase, securities lending and derivatives transactions in the euro zone. As such, the EMA replaces domestic master agreements for collateralised transactions, such as German and French master agreements for repurchase transactions.⁵⁴ The uniform provisions of the EMA cannot only be applied to document domestic transactions in all European Economic Area countries, but are also suitable for cross-border transactions.⁵⁵

53 For more information see the Commentary on the 2001 ISDA Cross-Agreement Bridge, issued by the ISDA.

54 See section 3 above.

55 The text of the agreement can be found on www.fbe.be. See also Lastenouse 2004.

The European Master Agreement (EMA) is a special agreement in that different financial products can be documented under it. The first edition of the EMA was issued in October 1999 and was designed for repurchase transactions and securities loans. This edition was revised in January 2001. A subsequent January 2004 edition of the EMA also makes it possible to enter into derivatives transactions under the EMA. Whereas repurchase, securities lending and derivatives transactions are documented in different agreements on the international level (e.g. the Global Master Repurchase Agreement, the Global Master Securities Lending Agreement and the ISDA Master Agreements respectively), in Europe these financial products can now be documented under one agreement, the EMA.⁵⁶

The EMA consists of General Provisions which apply to all financial products and which are negotiated in finer detail in the Special Provisions by the parties. The General and Special Provisions are complemented by Product Annexes. Three kinds of Product Annexes have been issued: for repurchase transactions, for securities lending and for derivatives transactions. In addition, a general Margin Maintenance Annex is available for all financial transactions concluded under the EMA.

The EMA offers cross-product facilities to be used both in 'normal circumstances' as well as in circumstances in which the parties wish to terminate their relationship prematurely. The cross-product character of the EMA becomes apparent when one examines the payment netting, the margin maintenance and the termination provisions of the agreement.

a. Payment netting

Section 3(4) of the General Provisions sets out the foundation for payment netting in respect of cash and/or other fungible assets under the EMA. This section makes it possible for parties to limit payment netting either to one transaction, or to a specified type of transaction (for example, to repos, securities lending and derivatives separately), although payment

⁵⁶ References to the EMA in the text below relate to the latest available edition of the constituents of the agreement, i.e. to the 2004 General Provisions, the 2004 Special Provisions, the 2001 Product Annex for Repurchase Transactions, the 2001 Product Annex for Securities Loans, the 2004 Product Annex for Derivative Transactions and the 2004 Margin Maintenance Annex.

netting may also be applied on a consolidated basis to all types of transactions under the EMA.⁵⁷

b. Margin maintenance

In the EMA, margin maintenance is regulated on a uniform basis in one Margin Maintenance Annex for repo, securities lending and derivatives transactions. The Product Annexes of these financial products contain provisions on margin maintenance which refer to the Margin Annex.⁵⁸ The Margin Annex basically provides several means of margin management: (1) per transaction; (2) per group of transactions (for example, by treating repos, securities lending and derivative transactions separately, or by distinguishing between transactions relating to fixed income and equity securities); (3) in relation to an aggregate of all transactions under the EMA, or (4) otherwise, as agreed by the parties.⁵⁹ As in the case of payment netting, margin maintenance can, therefore, also take place on a cross-product basis, if the parties so agree.

c. Termination

The termination provisions of the EMA also clearly show the cross-product character of the agreement. The EMA's General Provisions determine what happens when a termination event occurs which leads to a premature end to one or more transactions concluded between the parties. The uniform procedures concerning the termination, calculation and payment of a final settlement amount are set out in Sections 6 and 7 of the General Provisions. Transactions concluded under the EMA may be terminated prematurely in the event of a default or a change of circumstances.⁶⁰ The cross-product character of the EMA is particularly apparent in the case of a default. In the event of default, all the transactions under an agreement are terminated, i.e. all repo, securities lending and derivatives transactions. The consequences of a change of circumstances are usually limited to one or more transactions. For the transaction(s) terminated upon an event of default or a change of circumstances, a final

57 Parties make their choice in the Special Provisions (Section I(1) of the Elections and Amendments)

58 See Section 6(1) of the Repurchase Annex, Section 5 of the Securities Loan Annex and Section 3 of the Derivatives Annex.

59 See Section I(1) of the Margin Maintenance Annex, in conjunction with the Special Provisions (Section II(1) of the Elections and Amendments).

60 See Sections 6(1) ('Termination due to an Event of Default') and 6(2) ('Termination due to Change of Circumstances') of the EMA General Provisions respectively

settlement amount is established on the basis of Section 7 of the EMA. The final settlement amount is a single net amount payable by one of the parties.

5.4 'Master master' agreements

5.4.1 Introduction

A third way to link different financial products, in addition to bridge provisions and the documentation of different financial products in a single master agreement, is through so-called 'master master' agreements. Over the past decades, several master agreements for the documentation of different financial products have come into use. Examples of such master agreements are the Global Master Repurchase Agreement (GMRA) for repos, the Global Master Securities Lending Agreement (GMSLA) for securities lending arrangements and the ISDA's Master Agreements for derivatives. A 'master master' is an agreement that links master agreements for special financial products, notably in an event of default. Without a master master agreement, the situation upon default would be such that net sums payable arise under, for example, the GMRA, the GMSLA and the ISDA Master Agreements separately. Three payment obligations thus come into being. In this scenario, there is still a considerable level of counterparty risk. The effect of an additional master master agreement is that these three net sums payable are also netted, resulting in a single net sum payable. The result is a further limitation of risk. Master master agreements are, for example, used by the European Central Bank.⁶¹ Another relevant example of a master netting agreement is the Cross-Product Master Agreement discussed below.⁶²

5.4.2 Cross-Product Master Agreement

In February 2000, a number of associations representing the financial industry⁶³ launched the Cross-Product Master Agreement ('CPMA 1'). The

61 See Annex 2 to Guideline ECB/2000/1 (as amended)

62 The text of the Cross-Product Master Agreement can be found on www.bondmarkets.com

63 These associations include. The Bond Market Association, the British Bankers' Association, the Emerging Markets Traders Association, the Foreign Exchange Committee, the International Primary Market Association, the International Swaps and Derivatives Association, the Japan Securities Dealers Association, the London Investment Banking Association, and the Investment Dealers Association of Canada

goal of this master master agreement is to reduce risk by determining what should happen when two parties enter into multiple master agreements for specific financial transactions. The CPMA 1 considers situations in which a default takes place under one or more master agreements. It does not consider netting under 'normal circumstances'. Under the CPMA 1, an event of default arising under one agreement will, as a rule, also constitute an event of default under all other master agreements⁶⁴ and so-called 'uncovered' transactions, i.e. transactions between parties that do not fall within the framework of a standard agreement⁶⁵, to which the CPMA 1 applies. This means that all master agreements to which the CPMA 1 applies can be terminated. If the non-defaulting party elects that the CPMA 1 should indeed apply, not only will the agreement under which the default occurs be closed out, but so will all other agreements between the parties. It is not necessary for an event of default which leads to a CPMA 1 close-out to be envisaged in all agreements to which the CPMA 1 applies; it is sufficient that the event is an event of default under one of the agreements. Additional events of default may be specified in the CPMA 1 itself, while limitations may also be drafted regarding events of default in the underlying agreements which can trigger the applicability of the CPMA 1.

It is obvious that different agreements may contain different procedures for the determination of net settlement amounts. In order to take such different procedures into account, the CPMA 1 envisages (1) that each of the underlying agreements determines the way in which settlement amounts are to be calculated under that agreement, including time frames, and (2) that, under the CPMA 1, each time such a settlement amount falls due, it is to be set-off against settlement amounts which fell due earlier under other agreements. The process described under (2) continues and payment is deferred until all settlement amounts under the agreements falling under the CPMA 1 have been set off and a final net settlement amount has been reached. This final net settlement amount is the amount payable by one party to the other.⁶⁶

64 See the Schedule to the CPMA 1, Part I, which contains a list of master agreements which can be brought under the CPMA 1

65 When 'agreements' are referred to in this section, it is understood that they also refer to uncovered transactions

66 For a more detailed treatment of the CPMA 1, see the Guidance Notes to the agreement

The CPMA issued in February 2000 ('CPMA 1') is limited to bilateral relationships. In June 2003, the associations that had issued the CPMA 1 also issued the Cross-Product Master Agreement (Cross-Affiliate Version 2) ('CPMA 2'). The CPMA 2 has been designed to extend the risk-mitigating effects of CPMA 1 to a scenario in which multiple, affiliated entities have entered into multiple master agreements for specific financial products with a single common counterparty.⁶⁷

5.5 Practical application

In sections 5.2, 5.3 and 5.4 above, three means of linking flows of cash and securities under different financial products have been discussed. The results of the different cross-product arrangements that have appeared over the last decade are largely the same. In all circumstances, the parties reduce their counterparty risk because they net payment obligations under different financial agreements and have only one resulting net claim for the payment of money. One wonders under what circumstances a certain cross-product arrangement should be applied. To a large extent, this seems to depend upon the financial transactions that the parties usually conclude. For parties who regularly enter into derivatives transactions under ISDA documentation, opting for the ISDA Cross-Agreement Bridge is logical. For parties operating in the European repo, securities lending and/or derivatives markets, the EMA is an appropriate cross-product arrangement. In other relationships, the parties can opt for the CPMA to apply.

The choice of a particular cross-product agreement may also be influenced by the fact that the EMA does not only apply in the event of a default, but also under 'normal' circumstances, whereas the ISDA Cross-Agreement Bridge and the CPMA are designed for application in default situations only. Another significant factor has been pointed out by Lastenouse and relates specifically to default situations. The advantage of using the single agreement structure available to European market participants in the form of the EMA is that the contractual provisions of the EMA that set out events of default, valuation mechanisms and time frames, are identical for repurchase, securities lending and derivatives transactions. This leads to a reduction in the risk of mismatches between related transactions. Bridging different agreements, or applying a 'master master' agreement

67 For a further discussion of CPMA 2, see the text of the agreement and the Guidance Notes thereto.

can lead to mismatches because of differences in events of default, valuation mechanisms and time frames. In any case, the bridging approach and the 'master master' approach require careful legal drafting which takes into account different agreements, whereas the EMA is a single agreement with standardised provisions for all types of financial transactions involved.⁶⁸

In this context, the joint letter of TBMA and the ISDA, dated 15 October 2004 and relating to the regulatory treatment of securities financing transactions, is also noteworthy. It appears from this letter that the choice of the ISDA Cross-Agreement Bridge, the EMA or the CPMA is not relevant for regulatory purposes. In all instances, the reduction of counterparty risk will generally lead to lower capital adequacy requirements.

6. COMMERCIAL MARKET PARTICIPANTS

6.1 Introduction

Repurchase and securities lending arrangements are entered into on a very wide scale by commercial market participants.⁶⁹ Derivatives transactions, too, are very common and represent enormous values; this also holds true for margin collateral provided in the course of such transactions.⁷⁰ The bulk of transactions involving financial collateral are entered into between traders at the trading desks of major financial institutions. Sometimes an agreement and one or more transactions are also entered into on a more customized basis, in structured finance transactions, for example, but this is typically not the case. The text of the March 2001 Proposal for a Collateral Directive and the final text of the Collateral Directive give a good indication of the most important participants in the financial collateral markets.

6.2 The March 2001 Proposal for a Collateral Directive

Article 2(4) of the March 2001 Proposal for a Collateral Directive identifies the market participants to which the draft directive was intended to apply. It states:

68 See Lastenouse 2004, in particular the section on the 'Single Agreement Structure'.

69 See the European Repo Surveys mentioned in section 1 of chapter I.

70 See e.g. the ISDA Margin Survey 2005.

The collateral provider and the collateral taker must each be:

- (a) a public authority or a central bank;
- (b) a financial institution under prudential supervision; or
- (c) a person other than a natural person whose capital base exceeds EUR 100 million or whose gross assets exceed EUR 1000 million, at the time where financial collateral is actually delivered, according to the most recently prepared account published within a period no greater than two years prior to that time.

This rather simple formula related only to major market participants. Public authorities (such as ministries of finance), central banks and financial institutions under prudential supervision were intended to fall within the scope of the Collateral Directive. In addition, the directive was to be applicable to transactions between a collateral provider and a collateral taker who both met considerable quantitative requirements in respect of their capital base (minimum: 100 million euro) or gross assets (minimum: 1000 million euro).

6.3 The final text of the Collateral Directive

The final text of the Collateral Directive is far more detailed than that of the March 2001 Proposal. Article 1(2) of the Collateral Directive states:

The collateral taker and the collateral provider must each belong to one of the following categories:

- (a) a public authority (excluding publicly guaranteed undertakings unless they fall under points (b) to (e)) including:
 - (i) public sector bodies of Member States charged with or intervening in the management of public debt, and
 - (ii) public sector bodies of Member States authorised to hold accounts for customers;
- (b) a central bank, the European Central Bank, the Bank for International Settlements, a multilateral development bank as defined in Article 1(19) of Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions⁷¹, the International Monetary Fund and the European Investment Bank;
- (c) a financial institution subject to prudential supervision including:
 - (i) a credit institution as defined in Article 1(1) of Directive 2000/12/EC, including the institutions listed in Article 2(3) of that Directive;
 - (ii) an investment firm as defined in Article 1(2) of Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field⁷²;
 - (iii) a financial institution as defined in Article 1(5) of Directive 2000/12/EC;

71 OJ L 126, 26.5.2000, p. 1. Directive as amended by Directive 2000/28/EC (OJ L 275, 27.10.2000, p. 37).

72 OJ L 141, 11.6.1993, p. 27. Directive as last amended by Directive 2000/64/EC of the European Parliament and of the Council (OJ L 290, 17.11.2000, p. 27).

(iv) an insurance undertaking as defined in Article 1(a) of Council Directive 92/49/EEC of 18 June 1992 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance⁷³ and a life assurance undertaking as defined in Article 1(a) of Council Directive 92/96/EEC of 10 November 1992 on the coordination of laws, regulations and administrative provisions relating to direct life assurance⁷⁴,

(v) an undertaking for collective investment in transferable securities (UCITS) as defined in Article 1(2) of Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)⁷⁵,

(vi) a management company as defined in Article 1a(2) of Directive 85/611/EEC,

(d) a central counterparty, settlement agent or clearing house, as defined respectively in Article 2(c), (d) and (e) of Directive 98/26/EC, including similar institutions regulated under national law acting in the futures, options and derivatives markets to the extent not covered by that Directive, and a person, other than a natural person, who acts in a trust or representative capacity on behalf of any one or more persons that includes any bondholders or holders of other forms of securitised debt or any institution as defined in points (a) to (d),

(e) a person other than a natural person, including unincorporated firms and partnerships, provided that the other party is an institution as defined in points (a) to (d)

Subsections (a)-(d) of Article 1(2) of the Collateral Directive now contain a more detailed description of the major market participants. These include public authorities, central banks, the European Central Bank, financial institutions under prudential supervision (such as credit institutions, investment firms and insurance undertakings), central counterparties, settlement agents, clearing houses, and other comparable market participants. Essentially, this list more precisely defines the major market participants mentioned in the March 2001 Proposal.

It should, however, be noted that not all major market participants are mentioned in subsections (a)-(d) of Article 1(2) of the Collateral Directive. An example of a category that is absent is pension funds. It is likely that pension funds have not been mentioned in the Collateral Directive because the European directive regulating their activities⁷⁶ was adopted

73 OJ L 228, 11 8 1992, p. 1 Directive as last amended by Directive 2000/64/EC of the European Parliament and of the Council.

74 OJ L 360, 9 12 1992, p. 1 Directive as last amended by Directive 2000/64/EC of the European Parliament and of the Council

75 OJ L 375, 31 12 1985, p. 3 Directive as last amended by Directive 2001/108/EC of the European Parliament and of the Council (OJ L 41, 13 2 2002, p. 35)

76 Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision, Official Journal L 235, 23 9 2003, p. 10-21

in June 2003, roughly one year after the Collateral Directive. If interpreted broadly, a pension fund can indeed be considered a 'financial institution subject to prudential supervision' in the sense of Article 1(2)(c) of the Collateral Directive. Nevertheless, this example shows the weakness of the approach taken in the current version of the Collateral Directive, which sets out a list of major market participants. Some of them may not have been mentioned explicitly, which causes uncertainty. This disadvantage was overcome in the March 2001 Proposal discussed in section 6.2 above, by envisaging a fall-back provision including enterprises with a capital base or gross assets of a certain amount.

Moreover, the final text of the Collateral Directive contains a material change in comparison to the March 2001 Proposal. The final text of the Collateral Directive relates not only to major market participants, but, as a rule, relates to all persons other than natural persons. This follows in particular from subsection (e) of Article 1(2) of the Collateral Directive. Some caution is also required with regard to the entities mentioned in the second half of Article 1(2)(d), because 'a person [...]' who acts in a trust or representative capacity [...] for bondholders, for example, will often be a major market participant, but this is not always the case. The scope of applicability of the Collateral Directive has thus been widened considerably, as it now relates to small and medium-sized enterprises also. Small and medium-sized enterprises, however, are not traditional participants in the financial collateral markets, which are customarily operated through specialized trading desks.

To a large extent, the inclusion of enterprises, irrespective of their size, in the scope of the Collateral Directive seems to have resulted from pressure exerted by the International Swaps and Derivatives Association (ISDA) and the *Fédération Bancaire de l'Union Européenne* (FBE). In its Statement of Position in relation to the March 2001 Proposal for a Collateral Directive, the ISDA urged the European Parliament and the Council to widen the scope of the Collateral Directive to include all corporate counterparties. In its Preliminary Observations of October 2001 relating to the March 2001 proposal for a Collateral Directive, the FBE also argued for the application of the directive to both large and small commercial entities. The European Parliament has followed the suggestions of these bodies who represent the financial industry, and has proposed the inclusion of all companies in the scope of the directive provided that their counterparty is a financial

institution.⁷⁷ The Belgian Presidency of the European Union subsequently developed a proposal integrating the changes proposed by the European Parliament. In a letter of 3 December 2001 the ISDA and the FBE reacted as follows in a joint letter:

We strongly support an enlarged scope for the directive to include corporates of all sizes. We therefore welcome the Belgian Presidency's proposal, according to which corporates of all sizes would be included in the scope on the condition that the counterparty is either a financial institution or a public authority/central bank/other similar institution (Article 2 of the draft Directive).

On the 13 December 2001, the ECOFIN Council unanimously agreed upon the text proposed by the Belgian Presidency. The Common Position of 5 March 2002 also features a broad scope of applicability, to which the European Parliament subsequently agreed without any further amendments.⁷⁸

The types of enterprises mentioned in Article 1(2)(e) of the Collateral Directive may, however, be excluded from the scope of applicability of the Collateral Directive by the national legislator. Article 1(3) of the Collateral Directive states:

Member States may exclude from the scope of this Directive financial collateral arrangements where one of the parties is a person mentioned in paragraph 2(e). If they make use of this option Member States shall inform the Commission which shall inform the other Member States thereof.

The Council has introduced this provision because it feared that a broad scope of applicability of the Collateral Directive would, in an insolvency situation, be beneficial to the creditor under a financial collateral arrangement and detrimental to all other creditors of small and medium-sized enterprises. On the other hand, the Council did not want to exclude per definition small and medium-sized enterprises. It left the issue to be decided by the national legislator.⁷⁹ In light of the argument that a fair balance should be reached between the parties involved in financial collateral arrangements, this book advocates the exclusion of small and medium-sized enterprises.

77 See the Report of the European Parliament (amendments 5-9).

78 See the European Parliament's Recommendation for the Second Reading.

79 See the Common Position, p. 21.

7. CENTRAL BANKS

7.1 Introduction

Financial collateral arrangements are not entered into by commercial banks only. They are also very important to central banks, which apply financial collateral arrangements in order to conduct monetary policy. Moreover, central banks can use them for other purposes, such as for the management of foreign reserve assets. This section examines ways in which the European Central Bank (ECB) and the National Central Banks (NCBs) of the euro area make use of financial collateral. Section 7.2 deals with the monetary policy framework as it has functioned since the start of Stage Three of the Economic and Monetary Union (EMU) on 1 January 1999. The outline provided below makes clear that the provision of financial collateral in the course of reverse transactions (i.e. repurchase transactions or secured loans) or foreign exchange transactions, plays an important role in the monetary policy framework. This general outline is followed by an examination of the central role of reverse transactions in this framework. Section 7.3 describes how the NCBs in the euro area use financial collateral arrangements for the management of the foreign reserve assets of the ECB.⁸⁰

7.2 Monetary reverse transactions

7.2.1 *Monetary policy framework*

a. Introduction

The Eurosystem formulates and carries out the monetary policy in the euro area. The Eurosystem consists of the European Central Bank (ECB) and the National Central Banks (NCBs) of the countries of the European Union, which have adopted the euro as their single currency. Monetary policy is conducted in order to achieve the goals of the European System of Central Banks (ESCB)⁸¹, primarily price stability and also to support the general economic policies in the European Community.⁸² Monetary policy

80 On central banks and collateral see BIS 1999; BIS 2001 I, section 1.3. For more general background information, see e.g. Smits 1997 and Jansen 2001.

81 A distinction should be made between the Eurosystem and the ESCB. The ESCB consists of the ECB and of the NCBs of all countries belonging to the European Union (i.e. including those countries which have not yet adopted the euro).

82 See Article 2 of the Statute of the ESCB and the ECB.

decisions are taken by the Governing Council of the ECB, whereas the ECB's Executing Board is responsible for the implementation of these decisions. As a rule, for reasons of operational efficiency in particular, monetary policy decisions are executed on a decentralised level by the NCBs in the euro area.

The three main components of the monetary policy framework of the Eurosystem are: (1) the obligation for credit institutions to hold minimum reserves with the Eurosystem, (2) open market operations and (3) the standing facilities. One of the main objectives of these three 'pillars' of the monetary policy framework is to manage the liquidity in the euro area. These three pillars will now be discussed.⁸³

b. Minimum reserves

Minimum reserve requirements are the first pillar of the Eurosystem's monetary policy framework. One of the main goals of these reserve requirements is the creation of a structural liquidity shortage in the commercial markets. This goal is attained as follows. Minimum reserve requirements apply to commercial financial institutions. Such institutions are obliged to hold a certain amount of money in an account with a central bank. Because this money is no longer available in the market, the result is a structural liquidity shortage in the commercial markets. Because of this structural deficit, commercial market participants are interested in the liquidity that a central bank has to offer. The minimum reserve system therefore enables the Eurosystem to actively influence the amount of money in the market. Commercial market participants will be interested in entering into 'open market operations' (as described below) with a central bank in order to enhance their liquidity. Minimum reserves are, for this reason, a precondition for the effective management of the liquidity in the euro area. Without a structural liquidity shortage, commercial banks would not necessarily be interested in conducting open market operations with central banks.

Compliance with minimum reserve requirements is calculated on average over a period of about one month. This means that financial institutions are not always obliged to meet minimum reserves standards. Only at the end of each reserve maintenance period of about one month (over which

83 For a general outline of the single monetary policy framework in the euro area, see ECB 2004 I (in particular chapter 4) and ECB 2005.

the average of reserves is calculated), should they comply with the minimum reserve requirements. At that moment they must calculate the average of the daily balances of their reserve accounts over the whole reserve maintenance period. At the end of the maintenance period, the financial institution's average daily balances should match the minimum reserve requirements.⁸⁴

c. Open market operations

Open market operations are the second pillar of the Eurosystem's monetary policy framework. Open market operations are those operations through which central banks actually influence the liquidity in the euro zone. These operations are the core part of the Eurosystem's monetary policy framework, which, after all, aims to enhance or limit the overall liquidity in the euro zone. Open market operations are always executed on the initiative of the Eurosystem. They can be carried out in different ways. The most common instrument used to conduct open market operations is a reverse transaction (a repurchase transaction or a collateralised loan), however, outright sales and purchases, the issuance of central bank debt certificates, the collection of deposits, and foreign exchange swaps are also ways to execute open market operations. The 2004 publication on the monetary policy of the ECB clearly indicates the different instruments used to conduct open market operations by defining them as operations executed on the initiative of the central bank in the financial markets that involve one of the following transactions:

- (i) buying or selling assets outright (spot or forward); (ii) buying or selling assets under a repurchase agreement; (iii) lending or borrowing against underlying assets as collateral; (iv) issuing central bank debt certificates; (v) accepting fixed-term deposits; or (vi) conducting foreign exchange swaps between domestic and foreign currencies.⁸⁵

The different instruments mentioned in the definition of open market operations will now be discussed in more detail. The buying and selling of assets under a repurchase agreement (subsection ii of the definition) and the lending or borrowing against underlying assets as collateral

⁸⁴ See section 4.3 of ECB 2004 I and chapter 7 of ECB 2005 for more background information.

⁸⁵ See ECB 2004 I, p. 116. The definition of 'open market operation' in ECB 2004 II, p. 224 is less illuminating in this respect.

(subsection iii of the definition) will be considered together in subsection 2 below on reverse transactions.⁸⁶

1. Outright sales and purchases

The first way in which a central bank can influence liquidity is by conducting outright sales. A central bank can buy or sell euros on an outright basis, for example, in exchange for securities. When a central bank sells euros, this means that the euro liquidity of the markets is enhanced. When it buys euros, the total amount of euros in the commercial market decreases.

2. Reverse transactions

Central banks can also influence liquidity by way of reverse transactions. As will be shown in section 7.2.2, such transactions are most commonly applied in conducting open market operations. Reverse transactions are carried out in the form of a repurchase transaction or as a collateralised loan. The Annual Report of the ECB defines a 'reverse transaction' as 'an operation whereby the central bank buys or sells assets under a repurchase agreement or conducts credit operations against collateral'.⁸⁷

In the case of a reverse transaction carried out in the form of a repurchase transaction, a central bank usually buys securities from a commercial bank and pays the commercial bank in euros. This enhances the cash liquidity of the commercial bank and of the market in general. At the same time, the central bank and the commercial bank agree that, at a later moment in time, the euros will be returned to the central bank in exchange for securities equivalent to those transferred at the outset of the transaction.⁸⁸

Economically, such a repurchase arrangement is similar to a collateralised loan. In a collateralised loan, the central bank provides a commercial bank with euros in exchange for securities as collateral. The difference between a repurchase transaction and a collateralised loan is that in a collateralised

86 See section 4.4 of ECB 2004 I and chapter 3 of ECB 2005 for a description of open market operations.

87 See ECB 2004 II, p. 225.

88 The repurchase of *equivalent* securities has not been taken into account in the definition of 'repurchase agreement' in e.g. ECB 2004 I, p. 117; ECB 2004 II, p. 225; and ECB 2005, p. 83.

loan, the commercial bank retains title to the securities, whereas in a repo transaction it does not.

Originally, the Eurosystem distinguished two types of collateral eligible for use in repurchase transactions or collateralised loans. Only the securities listed as 'Tier One' or 'Tier Two' were suitable to serve as collateral in monetary reverse transactions. Tier One securities were recognised throughout the euro area. Tier Two securities were of particular importance for operations in individual countries. Currently the Tier One / Tier Two structure is being revised. There will ultimately be a single list of collateral eligible for use in monetary policy operations.⁸⁹

Reverse transactions as described above enhance the euro liquidity of the markets. These transactions are sometimes also used, however, to absorb liquidity. In such cases, a central bank sells securities to a commercial market participant in exchange for euros (repurchase transaction) or borrows euros against underlying collateral (collateralised loan).

3. Issuance of central bank debt certificates

The issuance of central bank debt certificates is a way for a central bank to decrease the liquidity of the markets. This is so because commercial banks will pay cash (usually euros) for these debt certificates.

4. Collection of deposits

The collection of deposits is another way to limit liquidity. In this case, commercial market participants are obliged to put a certain amount of money in an account with a central bank.

5. Foreign exchange swaps

It is also possible to influence the quantity of euros in the market by entering into foreign exchange swaps with domestic and foreign currencies. Basically, this means that foreign currencies are put into the

⁸⁹ See ECB 2005, chapter 6. On the revision process see the ECB Press Releases of 10 May 2004, 5 August 2004, 30 May 2005 and 22 July 2005; the ECB Governing Council decisions (other than decisions setting interest rates) of February 2005 and July 2005 (available on www.ecb.int); the Minutes of the meetings of the European Repo Council that took place in London on 21 October 2004 and in Luxembourg on 21 September 2005 (available on www.icma-group.org).

market in exchange for euros, which leads to a reduction of euro liquidity. Of course, the opposite is also possible: a central bank can put euros into the market in exchange for foreign currencies. Like reverse transactions, foreign exchange swaps usually have a second 'leg', i.e. after a certain period of time, a mirrored 'forward' transaction takes place. The effect on liquidity of foreign exchange swaps is therefore always limited by time.

d. Standing facilities

Standing facilities are the third and last pillar of the monetary policy framework. They are meant to manage overnight liquidity. Standing facilities offer solutions to commercial banks that have a shortage or a surplus of money at the end of the day. A commercial bank can make use of the 'margin lending facility' if it is in need of an amount of money at the end of the day. It can use a central bank's overnight 'deposit facility' if it has a surplus of money at the end of the day. Standing facilities are available to commercial market participants through their own initiative.

The 'marginal lending facility' is meant to provide euros to commercial banks that are not liquid enough at the end of the day. However, the rate set by central banks for this facility is the top rate in the market. The required liquidity is usually available on a cheaper basis with other commercial banks. A central bank is therefore a 'lender of last resort'.

The 'deposit facility' is meant to absorb a commercial bank's residual liquidity at the end of the day. For a commercial bank, it will always be better to lend this liquidity to another commercial bank, because the market rate this commercial bank pays is usually higher than the bottom rate set by the central bank.⁹⁰

7.2.2 The central role of reverse transactions

a. Introduction

Whereas section 7.2.1.c ('Open market operations') above outlines the instruments for influencing the liquidity in the euro area through open market operations, these operations can be further divided into four more specific categories, each with a specific goal: (1) main refinancing operations, (2) longer-term refinancing operations, (3) fine-tuning operations,

90 See section 4.5 of ECB 2004 I and chapter 4 of ECB 2005 for more information.

and (4) structural operations. Main and longer-term refinancing operations are the principal methods used to determine the market's level of liquidity on a regular basis. Fine-tuning operations are applied to manage sudden, unexpected changes in the level of liquidity. Structural operations allow the Eurosystem to adjust the amount of liquidity in the financial markets over the longer term.

The subsections below show that reverse transactions play a central role in these four types of open market operations. Moreover, reverse transactions are applied in the margin lending facility (see section 7.2.1.d ('Standing facilities') above). The central role of reverse transactions is also clear from the following table:

Eurosystem Monetary Policy Operations⁹¹

Monetary policy operations	Types of transactions		Maturity	Frequency
	Liquidity-providing	Liquidity-absorbing		

Open market operations

Main refinancing operations	* Reverse transactions	-	* One week	* Weekly
Longer-term refinancing operations	* Reverse transactions	-	* Three months	* Monthly
Fine-tuning operations	* Reverse transactions * Foreign exchange swaps * Outright purchases	* Foreign exchange swaps * Collection of fixed-term deposits * Reverse transactions * Outright sales	* Non-standardised	* Non-regular
Structural operations	* Reverse transactions * Outright purchases	* Issuance of debt certificates * Outright sales	* Standardised/non-standardised -	* Regular and non-regular * Non-regular

91 Source: ECB 2004 I, p. 73. See also ECB 2005, p. 11.

Standing facilities

Marginal lending facility	* Reverse transactions	-	* Overnight	* Access at the discretion of counterparties
Deposit facility	-	* Deposits	* Overnight	* Access at the discretion of counterparties

b. Refinancing operations

The most important monetary operations of the Eurosystem are refinancing operations. These operations are the main instrument used by the Eurosystem to influence the liquidity of the financial markets. They are conducted on the basis of reverse transactions with a fixed maturity. The so-called 'main refinancing operations' are the most important refinancing operations from a quantitative point of view. They take place weekly and have a maturity of one week.⁹² This frequency allows accurate determination of the liquidity in the euro area. If the Eurosystem determines that the overall liquidity of the commercial markets should be lowered, the total amount of outstanding reverse transactions will be lowered at the next weekly main refinancing operation. If liquidity ought to be enhanced, this can be done at the next weekly main refinancing operation by heightening the total volume of outstanding reverse transactions. 'Longer-term refinancing operations', which aim to provide longer-term liquidity, have a maturity of three months and are executed monthly. From a quantitative point of view, these longer-term refinancing operations are less important than the main refinancing operations. They are convenient, however, in placing euros in the market for a longer period of time. With main refinancing operations, the same result could only be reached by renewing or 'rolling over' outstanding transactions every week.

Refinancing operations are carried out on the basis of public tenders. In these tenders commercial banks offer a rate for the euros on sale. In the case of *main refinancing operations*, the Eurosystem sets a minimum bid

92 Before March 2004, reverse transactions entered into in the course of main refinancing operations normally matured after two weeks. For policy reasons, this term of maturity has been shortened to one week. See ECB 2004 I, p. 80 and Box 4.2 on p. 81.

rate.⁹³ Commercial banks offer this minimum rate or a higher rate. The highest bids are awarded first, followed by the bids with successively lower rates, until the Eurosystem has placed the total amount of money available in the market. If the bid of a commercial bank in the tender is indeed awarded, a reverse transaction can be carried out. In the case of a *longer-term refinancing operation*, no fixed minimum rate is set. In this case, the central bank acts as a 'rate taker', i.e. it accepts or does not accept the rate offered by a commercial bank. The minimum bid rate, or 'reverse rate' in a main refinancing operation is the most important central bank rate. This reverse rate is the central bank equivalent of a repo rate in the commercial market.

The three key rates of the Eurosystem are therefore:⁹⁴

----- rate for marginal lending facility (ceiling overnight rate)
 ----- **reverse rate**
 ----- rate for deposit facility (floor overnight rate)

The spread between the rate for the marginal lending facility and the reverse rate is commonly 1%. The spread between the key reverse rate and the rate for the deposit facility is also 1%. If, for example, the reverse rate is 3%, the ceiling overnight rate would be 4%, whereas the floor overnight rate in this instance would be 2%.⁹⁵

c. *Fine-tuning operations*

Reverse transactions can also be used in 'fine-tuning operations', which manage unexpected liquidity fluctuations in the market. It follows from the table above that this is the only instance in which reverse transactions can be used to both provide and absorb liquidity. In a liquidity-providing transaction, the Eurosystem sells euros for securities. In a liquidity-absorbing transaction, the Eurosystem buys euros for securities.

93 From early 1999 to June 2000 the Eurosystem conducted its main refinancing operations as fixed rate tenders. This, however, led to some instances in which severe overbidding took place. For this reason, the Eurosystem switched to a system of variable rate tenders combined with a minimum bid rate. See ECB 2004 I, pp. 80-82.

94 See also section 7.2.1.d ('Standing facilities') above.

95 The reverse rate is also applied for purposes other than monetary policy transactions. For example, the Dutch statutory interest (*wettelijke rente*) mentioned in Article 6:120(2) of the NCC is equal to the ECB reverse rate plus 0.7 %.

d Structural operations

In addition, reverse transactions can be used in 'structural operations' when the ECB wishes to adjust the structural liquidity position of the Eurosystem over the longer term vis-à-vis the financial sector. In fine-tuning operations and structural operations, however, a number of the other instruments listed in section 7.2.1.c ('Open market operations') can also be used.

e. Marginal lending facility

Finally, reverse transactions are the tool with which the marginal lending facility is executed (see section 7.2.1.d on 'Standing facilities' above). If a commercial bank wishes to make use of this facility and borrows money from the central bank, it should provide collateral to the central bank.

7.3 The management of foreign reserve assets of the ECB

Foreign reserve assets comprise foreign exchange reserves and holdings in gold, as well as claims against international institutions such as the IMF. Foreign reserve assets are traditionally used by central banks in conducting foreign exchange operations, such as interventions in the foreign exchange markets. At the beginning of Stage Three of the EMU, the NCBs transferred a part of their foreign reserve assets to the ECB in line with Article 30 of the Statute of the ESCB and the ECB. The NCBs now manage their own remaining foreign reserve assets and also the foreign reserve assets transferred to the ECB in line with Article 105⁹⁶ of the Treaty Establishing the European Community and Article 31 of the Statute of the ESCB and the ECB. Both in relation to their own foreign reserve assets and in relation to those of the ECB, the NCBs should act in accordance with the aims of the ESCB and in conformity with ECB policy decisions.⁹⁷ This section examines the management of the foreign reserve assets of the ECB

⁹⁶ See subsection 2, third indent, and subsection 3 of this provision

⁹⁷ A level of autonomy in respect of one's own foreign reserve assets remains in (1) transactions by NCBs in fulfilment of obligations towards international organizations, (2) transactions by NCBs under a certain limit, and (3) Member States' transactions with their foreign exchange working balances under a certain limit. See Article 105(3) of the Treaty Establishing the European Community and Article 31 of the Statute of the ESCB and the ECB

for which the ECB has issued specific guidelines in which repo and derivatives transactions play an important role.⁹⁸

The first published guideline, which sets out how the management of the foreign reserve assets of the ECB should take place is the Guideline on the Management of the Foreign Reserve Assets of the ECB (Guideline ECB/2000/1).⁹⁹ This Guideline was amended first in June and then November 2001, and again in September 2002, March and December 2005.¹⁰⁰

Guideline ECB/2000/1, as amended, sets out the standard documentation that should be used when entering into repo and derivatives transactions which involve the foreign reserve assets of the ECB. The standard Eurosystem documentation is based on master agreements used by commercial market participants such as the EMA, the GMRA, the TBMA Master Repurchase Agreement and ISDA documentation.¹⁰¹ The standard documentation used in the commercial markets, however, is adapted so as to take into account the special nature of transactions with a central bank. For example, the specific Eurosystem provisions contain a strict confidentiality clause (along the lines of Article 38 of the Statute of the ESCB and the ECB) and a special clause on the immunity of the ECB (in line with Article 40 of the Statute of the ESCB and the ECB).¹⁰²

Guideline ECB/2000/1 contains an Annex concerning cross-product netting arrangements.¹⁰³ In addition, the Guideline ECB/2002/6 of September 2002 sets out minimum standards for the conduct of the personnel of NCBs which apply when it handles the ECB's foreign reserve assets.

98 On foreign exchange operations and official foreign reserves, see also Smits 1997, pp. 197-202.

99 Earlier versions of this Guideline were not made public.

100 For sources, see the overview of Legislation, Guidelines and Principles at the end of this book.

101 See the latest version of Annex 3 on 'Standard agreements for collateralised operations, over-the-counter derivatives operations and deposits' in the March 2005 Amendment to Guideline ECB/2000/1, as amended by the December 2005 Amendment to Guideline ECB/2000/1.

102 See Article 3(2) and Annex 1 of Guideline ECB/2000/1, as amended by the November 2001 and March 2005 Amendments to Guideline ECB/2000/1.

103 See Article 3(3) and Annex 2 of Guideline ECB/2000/1, as amended by the March 2005 and December 2005 Amendments to Guideline ECB/2000/1.

8. THE COLLATERAL DIRECTIVE

8.1 Introduction

The Directive of the European Parliament and of the Council on financial collateral arrangements ('Collateral Directive')¹⁰⁴ is an important step towards achieving a uniform legal regime for collateralised transactions in the European Union.¹⁰⁵ This section examines the main provisions and 'opt-out' clauses of the Collateral Directive and will consider the practical application of the opt-out clauses in the Netherlands, the United Kingdom and Germany. A further legal analysis of core issues in property and insolvency law will take place in chapters III, IV and V.

Section 8.2 begins by setting out the limitations to the Collateral Directive. These limitations are important in light of the far-reaching consequences of the Collateral Directive. The two methods set out in the Collateral Directive for the provision of financial collateral will then be examined. First, section 8.3 explores the way in which the Collateral Directive approaches title transfer structures and the risk of such a structure being recharacterised as a security interest. Second, section 8.4 considers the introduction of a security interest combined with a general right of disposal for the collateral taker (a 'right of use'). Furthermore, the way in which the Collateral Directive addresses the enforceability of margin transfers and substitution arrangements will be discussed in sections 8.5 and 8.6 respectively.

The Collateral Directive also contains provisions relating to the enforcement of financial collateral. Such enforcement takes place upon the occurrence of an enforcement event and means that the parties terminate their contractual relationship. The Collateral Directive addresses two important issues in this respect: the manner of enforcement and the (non-) applicability of certain provisions of insolvency law. The first of these,

104 See the list of official documents that appeared in the course of the legislative history of the Collateral Directive at the end of this book

105 In studies which were carried out before the introduction of the Collateral Directive, divergent legal practices in the Member States of the European Union were pinpointed as an obstacle to the development of a liquid cross-border collateral market in the European Union. See, for example, Giovannini 1999, Ciampolini / Rohde 2000, the ISDA Report 2000, and the analysis by the European Financial Market Lawyers Group (EFMLG) in the EFMLG Proposal for an EU Directive on Collateralisation (this latter document also forms Annex F of the Commission Working Document)

relating to the enforcement regime envisaged in the Collateral Directive, is addressed in section 8.7. If a security interest has been established in respect of financial collateral, the secured party can apply the liberal enforcement regime set out in the Collateral Directive. If financial collateral has been transferred outright, enforcement is effectuated by invoking contractual close-out netting provisions, a method sanctioned by the Collateral Directive. The topic of section 8.8 is the approach of the Collateral Directive with regard to national provisions of insolvency law that may apply in the enforcement of financial collateral. In this instance, the Collateral Directive follows the approach that was taken earlier in the Settlement Finality Directive. Like the Settlement Finality Directive, the Collateral Directive contains provisions that (1) prohibit the retroactive effect of a declaration of insolvency by a court; (2) allow under certain circumstances the enforceability of legal acts concluded after the moment of such a declaration; and (3) render inoperable a freeze period that possibly applies in insolvency.^{106 107}

8.2 Scope of the Collateral Directive

8.2.1 Introduction

Article 1 of the Collateral Directive limits its scope in three ways: (1) it allows the directive to apply only to financial products that involve collateral in the form of cash or securities ('financial collateral'); (2) it states that collateral arrangements must fulfil certain requirements to fall within the scope of the Collateral Directive; and (3) it allows the directive to apply only to transactions between certain market participants. In addition to the limitations that follow from the text of the Collateral Directive itself, a further limitation is possible in connection with the two functions of recovery and tradeability that financial collateral usually fulfils.

106 This study does not address issues of private international law. For this reason, Article 9 of the CD, which sets out conflict of law rules in respect of book-entry securities, is not discussed in this section.

107 For a basic introduction to the Settlement Finality Directive and the Collateral Directive, see e.g. Goode / Kronke / McKendrick / Wool 2004, chapter 9, and Johansson 2005, in particular sections 3 and 4. For more information about the Settlement Finality Directive, see Vereecken / Nijenhuis 2003; and Pitt 2003. For general information on the Collateral Directive, see also Cooley 2001, Clifford Chance 2002, and Turing 2002.

8.2.2 Financial collateral

The Collateral Directive is limited to financial collateral in the form of cash or financial instruments.¹⁰⁸ Article 2(1)(d) of the Collateral Directive defines cash as 'money credited to an account in any currency, or similar claims for the repayment of money, such as money market deposits'. This means that cash in hand (banknotes and coins) falls outside the scope of the Collateral Directive.¹⁰⁹ Article 2(1)(e) defines financial instruments as:

shares in companies and other securities equivalent to shares in companies and bonds and other forms of debt instruments if these are negotiable on the capital market, and any other securities which are normally dealt in and which give the right to acquire any such shares, bonds or other securities by subscription, purchase or exchange or which give rise to a cash settlement (excluding instruments of payment), including units in collective investment undertakings, money market instruments and claims relating to or rights in or in respect of any of the foregoing

These financial instruments will be referred to hereafter as securities. The most important quality of these securities is that they are actually tradable in a market.

As shown above, financial collateral in the form of cash or securities is typically provided in repos, securities lending agreements and derivatives. The Collateral Directive does not, for example, extend to transactions with commodities (e.g. grain, or precious metals) as collateral.

A first 'opt-out' provision is set out in Article 1(4)(b) of the Collateral Directive. This provision states:

Member States may exclude from the scope of this Directive financial collateral consisting of the collateral provider's own shares, shares in affiliated undertakings within the meaning of seventh Council Directive 83/349/EEC of 13 June 1983 on consolidated accounts¹¹⁰, and shares in undertakings whose exclusive purpose is to own means of production that are essential for the collateral provider's business or to own real property.

The most important part of this provision relates to transactions in which the collateral provider transfers financial collateral, the value of which is closely linked to the financial position of the collateral provider. The

108 See Article 1(4)(a) of the CD.

109 See also recital 18 of the CD.

110 OJ L 193, 18.7.1983, p. 1. Directive as last amended by Directive 2001/65/EC of the European Parliament and of the Council (OJ L 283, 27.10.2001, p. 28).

national legislator does not have to apply the provisions of the Collateral Directive to such transactions. The value of the collateral is closely connected to the financial position of the collateral provider, if, for example, the collateral provider transfers securities that he has issued himself, or securities issued by enterprises whose existence depends on the economic well-being of the collateral provider (e.g. a contractor that almost exclusively supplies the collateral provider). And indeed, if the collateral provider were to run into financial difficulties in such instances, there is the added risk of such financial collateral turning out to be worthless as an object for recovery. It is likely that the value of such securities would decrease substantially and that the market for such securities would become non-liquid. In addition, Article 1(4)(b) of the Collateral Directive makes it possible to exclude shares in undertakings whose exclusive purpose is to own real estate. This provision was included to meet the needs of a Member State (not the Netherlands), in which houses are usually owned by enterprises that have been established for this purpose only.¹¹¹

The Netherlands and the United Kingdom have not made use of this opt-out possibility.¹¹² In Germany, a limited use of the opt-out clause is made. If an entity mentioned in Article 1(2)(e) of the Collateral Directive, such as a small or medium-sized enterprise, provides collateral in the form of his own shares or shares of defined affiliated enterprises, such collateral does not fall within the scope of the German law implementing the Collateral Directive.¹¹³

8.2.3 Requirements

Article 1(5) of the Collateral Directive sets out two requirements which collateral arrangements have to meet in order to fall within the scope of the Collateral Directive. Financial collateral must actually be provided, and it must be possible to produce evidence of the provision of financial

111 See *Tweede Kamer* 2002-2003, 28 874, no. 3, pp. 3-4; *Tweede Kamer* 2004-2005, 30 138, no. 3, p. 4.

112 For Dutch law, see the definition of 'securities' (*effecten*) in Article 7:51(e) of the NCC. The Explanatory Notes (*Tweede Kamer* 2002-2003, 28 874, no. 3, pp. 3-4; *Tweede Kamer* 2004-2005, 30 138, no. 3, p. 4) in relation to this provision do not explain why financial collateral, the value of which is closely linked with the financial position of the collateral provider, has not been excluded. For UK law, see the definition of 'financial instruments' in Regulation 3 of the Financial Collateral Arrangements (No. 2) Regulations 2003.

113 See § 1(17) of the *Kreditwesengesetz*.

collateral as well as evidence of the financial collateral arrangement itself. The text of Article 1(5) of the Collateral Directive states:

This Directive applies to financial collateral once it has been provided and if that provision can be evidenced in writing

The evidencing of the provision of financial collateral must allow for the identification of the financial collateral to which it applies. For this purpose, it is sufficient to prove that the book entry securities collateral has been credited to, or forms a credit in, the relevant account and that the cash collateral has been credited to, or forms a credit in, a designated account

This Directive applies to financial collateral arrangements if that arrangement can be evidenced in writing or in a legally equivalent manner

The first requirement is that financial collateral must be provided. Generally, the approach of the Collateral Directive is that the provision of collateral should not depend on any formal act. The only real requirement is – to paraphrase recital 10 of the Collateral Directive – that some form of dispossession should take place on the part of the collateral provider. This means that the collateral provided should come into the possession of or fall under the control of the collateral taker or of a person acting on his behalf. Article 2(2) of the Collateral Directive states:

References in this Directive to financial collateral being 'provided', or to the 'provision' of financial collateral, are to the financial collateral being delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker or of a person acting on the collateral taker's behalf. Any right of substitution or to withdraw excess financial collateral in favour of the collateral provider shall not prejudice the financial collateral having been provided to the collateral taker as mentioned in this Directive¹¹⁴

It should, nonetheless, be noted that recital 10 of the Collateral Directive also makes clear that formal requirements under national law for the transfer or the vesting of a security interest in relation to financial instruments other than book-entry securities (such as endorsement in the case of instruments to order, or recording on the issuer's register in the case of registered instruments), do not have to be rendered inapplicable.¹¹⁵

Secondly, Article 1(5) makes clear that the parties to a financial collateral arrangement must be able to produce evidence of the existence of the

114 See also recitals 9 and 10 and Article 3 of the CD

115 The issue of formal requirements for the transfer or establishment of a right of pledge in relation to financial instruments is not discussed further

actual arrangement and of the provision of financial collateral under such an arrangement. The provision of financial collateral must be evidenced in writing, which includes recording by electronic means or any other durable medium.¹¹⁶ The existence of the financial collateral arrangement can be evidenced in writing, including recordings by electronic means or any other durable medium, or in a legally equivalent manner.¹¹⁷

8.2.4 Market participants

The provisions concerning the market participants to which the Collateral Directive applies have been discussed in section 6 above. For the sake of legal clarity, the present text of Article 1(2) of the Collateral Directive aims to provide an exhaustive list of these market participants. Article 1(2) is broad in scope and relates to both major participants in the financial markets and to small and medium-sized enterprises. Only transactions between small and medium-sized enterprises and transactions involving individual consumers are not covered by the Collateral Directive. At least one major market participant should be a party to a financial collateral arrangement for the Collateral Directive to apply.

Article 1(3) of the Collateral Directive contains a second 'opt-out' possibility for the national legislator. Member States may exclude from the scope of the directive financial collateral arrangements entered into by entities listed in Article 1(2)(e) which will, in practice, often be collateral arrangements entered into by small and medium-sized enterprises.¹¹⁸ The United Kingdom has not made use of this option. The British regulations implementing the Collateral Directive envisage an even wider scope than the Collateral Directive. The regulations apply to all transactions with financial collateral, except to those involving natural persons.¹¹⁹ The Netherlands has also not made use of the opt-out possibility set out in Article 1(2)(e) of the Collateral Directive. The Dutch implementing law, however, quite strictly follows the text of the Collateral Directive and, unlike the British regulations, does not extend its scope.¹²⁰ On the basis of § 1(17) of the German *Kreditwesengesetz*, financial collateral arrangements

116 See Article 2(3) of the CD.

117 On the issue of evidence, see also recitals 10 and 11 and Article 3(2) of the CD.

118 For the text of the opt-out clause, see section 6.3 above or Appendix 2.

119 See the definitions of 'non-natural persons', 'security financial collateral arrangement' and 'title transfer financial collateral arrangement' in Regulation 3 of the Financial Collateral Arrangements (No. 2) Regulations 2003.

120 See Article 7:52 of the NCC, and section 9.2.2 below.

under German law can be entered into with the entities mentioned in Article 1(2)(e) of the Collateral Directive, who are also able to enter into such arrangements amongst themselves. If the collateral provider is an entity mentioned in Article 1(2)(e) of the Collateral Directive, the arrangement should nonetheless meet certain requirements, i.e. the agreement between the parties should relate to a purchase or a disposal of financial instruments, there should be a repurchase, a securities lending or comparable transaction, or the parties should agree on a loan of fungibles in order to finance the buy-in of financial instruments.¹²¹ Generally, most Member States seem to have applied the Collateral Directive to transactions between major financial institutions, and between such institutions and other enterprises. Only a limited number of Member States have applied the opt-out possibility of Article 1(3) of the Collateral Directive, or, on the contrary, have taken a more liberal approach that does not require one of the counterparties to be a major financial institution for a transaction to fall within the scope of the directive.¹²²

8.2.5 *Interpretation of the Collateral Directive: two functions of collateral*

One of the central issues of interpretation arising in connection with the Collateral Directive is the scope of the term 'financial collateral arrangement'. Is it that only arrangements that serve both a recovery and a tradeability function fall within the scope of this term, or are arrangements that serve a recovery function only also covered? The answer to this question is uncertain. In any case, it is clear that the Collateral Directive applies to financial products in which financial collateral serves both a recovery and a tradeability function. As was shown in section 2.4 above, these two functions are customarily present in repurchase, securities lending, and certain derivatives transactions. It is, however, open to debate whether the Collateral Directive should be interpreted extensively, and relate to transactions that are not characterised by both functions. An extensive interpretation would mean that traditional security interests (such as a pledge without a right of use, or a fiduciary transfer of title) would also fall within the scope of the Collateral Directive. Such traditional security interests serve a recovery function only. In this instance, the collateral taker does not have an unlimited right of disposal in respect of the collateral provided and the tradeability function is absent.

121 See Löber 2005 on the German approach.

122 For more information and further references see also section 3.2 of chapter VI.

Since the Collateral Directive generally enforces the position of credit providers/collateral takers, financial institutions will naturally be inclined towards an extensive interpretation of the term 'financial collateral arrangement', which would include traditional security interests. However, the analysis in the chapters below shows that such an interpretation may have negative consequences for collateral providers, such as small and medium-sized enterprises in particular. The argument that those in a weaker position deserve a level of protection supports the more restrictive interpretation of the Collateral Directive proposed in chapter VI.

8.3 Title transfers: no recharacterisation

Article 6 of the Collateral Directive sanctions the enforceability of title transfer arrangements. The text of this provision reads as follows:

Member States shall ensure that a title transfer financial collateral arrangement can take effect in accordance with its terms

Before the introduction of the Collateral Directive a recharacterisation risk was perceived in collateralised transactions in a number of countries of the European Union. Recharacterisation means that an outright transfer of title is treated as a security interest in line with the actual intentions of the parties in the course of legal proceedings, for example. The Collateral Directive is intended to eliminate this risk. In recital 13 of the Collateral Directive, this is phrased as follows:

This Directive seeks to protect the validity of financial collateral arrangements which are based upon the transfer of the full ownership of the financial collateral, such as by eliminating the so-called re-characterisation of such financial collateral arrangements (including repurchase agreements) as security interests

The rationale behind the approach of the Collateral Directive is that the recharacterisation of a title transfer as a security interest can, under ordinary national rules of law, have serious implications for the collateral taker. For instance, the collateral taker could forfeit all his rights to the collateral if a title to transfer assets for recovery purposes is considered to be invalid under national law, or if mandatory requirements for the establishment of the security interest should have been met.

It is not certain whether Article 6 of the Collateral Directive also applies to fiduciary transfers of title. Fiduciary arrangements are somewhat hybrid in character. On the one hand, there is a transfer of title, on the

other, the main purpose of the arrangement is to give the transferee an object for recourse. This prompts the question of whether a fiduciary transfer of financial collateral should be characterised as a 'title transfer financial collateral arrangement' or a 'security financial collateral arrangement' in the sense of the Collateral Directive.¹²³ From a formal point of view, one could argue that under Dutch and German law a fiduciary transfer is primarily a transfer, under which the rights of the transferee are subsequently limited in a number of ways. According to this view, a fiduciary arrangement is a 'title transfer financial collateral arrangement' in the sense of the Collateral Directive. However, a fiduciary transfer of title is essentially a security interest. For those who allow substance to prevail over form, it is therefore logical to characterise a fiduciary arrangement as a 'security financial collateral arrangement'. A far more important question, however, is whether fiduciary arrangements fall within the scope of the Collateral Directive at all. This book advocates the view that fiduciary transfers should not fall within the scope of the Collateral Directive because the rights of a fiduciary are confined to recovery, which excludes the second characteristic function of financial collateral, namely tradeability. This approach is intended to protect collateral providers against credit providers, who are often in a stronger position.¹²⁴

8.4 Security interests: right of use

If collateral is provided by way of the security interest method, Article 5 of the Collateral Directive allows the establishment of a so-called 'right of use' in respect of that collateral for the benefit of the collateral taker. Article 5 of the Collateral Directive on the right of use of financial collateral under security financial collateral arrangements reads as follows:

1. If and to the extent that the terms of a security financial collateral arrangement so provide, Member States shall ensure that the collateral taker is entitled to exercise a right of use in relation to financial collateral provided under the security financial collateral arrangement.
2. Where a collateral taker exercises a right of use, he thereby incurs an obligation to transfer equivalent collateral to replace the original financial collateral at the latest on the due date for the performance of the relevant financial obligations covered by the security financial collateral arrangement. Alternatively, the collateral taker shall, on the due date for the performance of the relevant financial

123 See the definitions in Articles 2(1)(b) and 2(1)(c) of the CD.

124 See also section 8.2.5 above. For a further elaboration of fiduciary transfers of ownership and the limitations to which they are subject, see sections 3.2.2 and 3.2.3 of chapter III below.

obligations, either transfer equivalent collateral, or, if and to the extent that the terms of a security financial collateral arrangement so provide, set off the value of the equivalent collateral against or apply it in discharge of the relevant financial obligations

3 The equivalent collateral transferred in discharge of an obligation as described in paragraph 2, first subparagraph, shall be subject to the same security financial collateral agreement to which the original financial collateral was subject and shall be treated as having been provided under the security financial collateral arrangement at the same time as the original financial collateral was first provided

4 Member States shall ensure that the use of financial collateral by the collateral taker according to this Article does not render invalid or unenforceable the rights of the collateral taker under the security financial collateral arrangement in relation to the financial collateral transferred by the collateral taker in discharge of an obligation as described in paragraph 2, first subparagraph

5 If an enforcement event occurs while an obligation as described in paragraph 2 first subparagraph remains outstanding, the obligation may be the subject of a close-out netting provision

A right of use means that the collateral taker has the right to dispose of the collateral in favour of a third party by transferring ownership or by vesting a security interest. Article 2(1)(m) defines a right of use as 'the right of the collateral taker to use and dispose of financial collateral provided under a security financial collateral arrangement as the owner of it in accordance with the terms of the security financial collateral arrangement'. By introducing the possibility of granting a general right of disposal to collateral takers, the Collateral Directive enhances the liquidity of the cash and securities markets.¹²⁵

If the collateral taker exercises his right of use, he becomes obliged to transfer equivalent assets to the collateral provider. He must do so at the end of the transaction at the very latest. The equivalent collateral is subject to the same financial collateral arrangement as the collateral originally provided, and is treated as if it has been provided at the same time that the original collateral was first provided. The equivalent collateral is thus a substitute for the original collateral.¹²⁶

125 See recital 19 of the CD

126 On the legislative history of the 'right of use' see the Commission Working Document, p 12, Annex A, p 7 and 8, Annex B (in particular section 3), and Annex F, p 11 of the Commission Working Document; and the different proposed texts in respect of the right of use provision throughout the legislative process leading to the Collateral Directive. See also the 2001 ISDA Statement of Position in relation to the March 2001 Proposal

Before the introduction of the right of use in the European Collateral Directive, a security interest combined with a general right of disposal occurred in the American financial markets. The right of use envisaged by the Collateral Directive, however, seems incompatible with the systems of property law of many, if not all, European countries. After all, it is in keeping with the nature of a security interest that the beneficiary thereof is only entitled to dispose of the object in respect of which he has a right, if the collateral provider defaults. His rights are limited to having recourse to the proceeds of the financial collateral up to the amount of the secured claim which he has against the provider of security. It is therefore unlikely that an unlimited right of disposal under 'normal circumstances' is consistent with the nature of a security interest.

A security interest combined with a right of use is investigated further in chapter IV. As stated in section 8.2.5 above, this book examines whether the Collateral Directive applies only to liquidity-enhancing security interests combined with a right of use, or if it is also applicable to traditional security interests in respect of financial collateral (i.e. those interests) without a general right of disposal for the collateral taker).¹²⁷

8.5 Margin transfers

Article 8(3)(a) of the Collateral Directive offers protection to margin transfers that occur in the course of a transaction.¹²⁸ Article 8(3) of the Collateral Directive reads as follows:

Where a financial collateral arrangement contains:

(a) an obligation to provide financial collateral or additional financial collateral in order to take account of changes in the value of the financial collateral or in the amount of the relevant financial obligations, or

(b) a right to withdraw financial collateral on providing, by way of substitution or exchange, financial collateral of substantially the same value,

Member States shall ensure that the provision of financial collateral, additional financial collateral or substitute or replacement financial collateral under such an obligation or right shall not be treated as invalid or reversed or declared void on the sole basis that:

¹²⁷ See also section 8.2.5 above.

¹²⁸ See also section 4.3 ('Margin maintenance') above. Note that Article 8(3)(a) of the CD calls margin transfers the 'provision of financial collateral or additional financial collateral', whereas recitals 5 and 16 of the CD speak of 'top-up collateral'. On margin transfers see also recital 9 and the last sentence of Article 2(2) of the CD ('withdrawal of excess collateral').

- (i) such provision was made on the day of the commencement of winding-up proceedings or reorganisation measures, but prior to the order or decree making that commencement or in a prescribed period prior to, and defined by reference to, the commencement of winding-up proceedings or reorganisation measures or by reference to the making of any order or decree or the taking of any other action or occurrence of any other event in the course of such proceedings or measures, and/or
- (ii) the relevant financial obligations were incurred prior to the date of the provision of the financial collateral, additional financial collateral or substitute or replacement financial collateral

The overall purpose of this provision is to prevent any uncertainty surrounding the provision of margin collateral. First, it is not possible to question a margin transfer solely on the basis that it was carried out on the day that insolvency proceedings¹²⁹ commenced, but before the actual declaration of the start of such proceedings. This means that an insolvency takes effect at the actual moment the insolvency is declared, and that the declaration of insolvency should not be applied retroactively to the beginning of the day of that declaration. In addition, the provision of margin cannot be questioned solely on the basis that it is provided during a 'prescribed' period before insolvency (e.g. under a provision of national law intended to protect the joint creditors of the insolvent party by stating that all transactions entered into by the insolvent party during a defined period before insolvency are automatically invalid).¹³⁰ Third, the provision of margin cannot be declared invalid solely on the basis that the margin collateral was provided after the date that the obligation secured by that collateral arose.

An important advantage of the regular provision of margin (e.g. daily) is that the credit exposures between the parties are kept to a minimum. Thus, margin transfers serve a recovery function. Moreover, where margin cash and securities can also be used to enter into further trading, they promote the liquidity of the market.¹³¹

Note that the Collateral Directive only mentions margin transfers that are related to price fluctuations in the market. Margin transfers related to a lower credit rating fall outside the scope of the directive. The reasoning behind this is that a lower credit rating may anticipate insolvency and

129 On the term 'insolvency proceedings' see the introduction to section 8.8 below
 130 Compare the approach to 'prescribed periods' set out in recital 16 and in Articles 8(1) and 8(4) of the CD
 131 On the economic function of marking-to-market and margining see BIS 1999, sections 4.5.1 and 4.5.2

that, if insolvency were to occur, such a margin transfer would adversely affect the position of other creditors of the transferor of margin.¹³² Such a transfer may also amount to fraud or a similar breach of avoidance rules in order to protect the joint creditors of the insolvent estate.¹³³

8.6 Substitution

A right of substitution permits the transferor of securities to substitute the securities originally provided with other acceptable collateral. A right of substitution can only be exercised with the consent of the counterparty. If no agreement to this effect is made beforehand, consent must be obtained during the course of the transaction.¹³⁴

Article 8(3) of the Collateral Directive, which was cited in section 8.5 above, also applies to substitution arrangements. Subsection 8(3)(b) of the Collateral Directive offers the same kind of protection to substitution arrangements as it does to margin transfers.¹³⁵ This means that the substitution of securities cannot be questioned solely on the basis that it takes place on the day that insolvency proceedings are commenced, but before the actual start of such proceedings, which implies that a declaration of insolvency should not be applied retroactively to the beginning of the day it was issued. Nor is substitution invalid merely because it takes place during a 'prescribed' period before insolvency. Moreover, substitution cannot be questioned solely on the basis that the substitute securities that take the place of the original securities are transferred on a date later than that on which the obligation they secure came into existence. The protection offered by Article 8(3) of the Collateral Directive does not impair the possibility of invalidating the substitution of securities if it is intentionally done to the detriment of other creditors in a prescribed period prior to insolvency.¹³⁶

Substitution has an impact on the liquidity of the markets. On the one hand, the right of substitution enhances the flexibility of the securities portfolio of the collateral provider (who may now be able to enter into transactions which would otherwise have been impossible without a right

132 See, in particular, the examination of Article 9 of the CD in the Explanatory Memorandum to the Collateral Directive (March 2001 Proposal).

133 See recital 16 and Article 8(4) of the CD.

134 See also section 4.4 ('Substitution') above.

135 See also recitals 5, 9 and 16 and Article 2(2) of the CD.

136 See recital 16 and Article 8(4) of the CD.

of substitution) and, as such, fosters liquidity. On the other hand, the substitution arrangement restricts the collateral taker if he gave his prior consent to substitutions. In such cases, the collateral taker must ensure that equivalent collateral is available to the collateral provider whenever the latter invokes his right of substitution, and he must bear this in mind when trading with the collateral provided. Thus, the right of substitution enhances the liquidity of financial collateral from the point of view of the collateral provider, while it may put a strain on liquidity from the perspective of the collateral taker. On the whole, however, substitution arrangements contribute to flexible and liquid markets.¹³⁷

8.7 Manner of enforcement

8.7.1 Introduction

One of the aims of the Collateral Directive is to guarantee the rapid enforcement of financial collateral upon the occurrence of an enforcement event. Enforcement events are events which lead to the premature termination of the contractual relationship between the parties to an agreement (either automatically or after notice is given). Insolvency is usually specified as an enforcement event, but other, non-insolvency related events can also lead to the early termination of the contractual relationship. The contractual relationship is not necessarily terminated completely; a so-called 'mini-close-out' of specified transactions is also possible.¹³⁸

The Collateral Directive deals with the issue of enforcement in two separate articles. Article 4 of the directive covers the enforcement of a security interest, while Article 7 relates to the recognition of close-out netting when collateral has been provided by way of a title transfer. The Collateral Directive stipulates that it must be possible to put contractual enforcement mechanisms in place, whether these relate to financial collateral that has been provided by establishing a security interest or on the

137 Rights of substitution as a means of encouraging liquidity are under discussion by the European Repo Council (ERC). See, for example, the Minutes of the ERC Steering Committee Meeting of 20 November 2000, the Minutes of the New York Meeting between the International Securities Market Association's ERC Steering Committee and The Bond Market Association's North American Repo Council of 13 December 2000, the Minutes of the ERC General Meetings of 15 January 2001 and 14 May 2001. Some of these documents are available on www.icma-group.org. See also BIS 1999, section 4.5.7.

138 Cf. the definition of 'enforcement event' in Article 2(1)(l) of the CD. See also section 4.7 above on events of default.

basis of a title transfer. As is shown below, under the directive the enforcement of financial collateral may not be subject to statutory requirements under national laws, such as a notice prior to enforcement or a prescribed method of sale (e.g. a public sale or a sale approved by a judge). Under the Collateral Directive, financial collateral can be immediately enforced in line with contractual provisions.¹³⁹

8.7.2 *Security interests: a liberal enforcement regime*

Article 4 of the Collateral Directive relates to the enforcement of security financial collateral arrangements and reads as follows:

1 Member States shall ensure that on the occurrence of an enforcement event, the collateral taker shall be able to realise in the following manners, any financial collateral provided under, and subject to the terms agreed in, a security financial collateral arrangement

(a) financial instruments by sale or appropriation and by setting off their value against, or applying their value in discharge of, the relevant financial obligations, (b) cash by setting off the amount against or applying it in discharge of the relevant financial obligations

2 Appropriation is possible only if:

(a) this has been agreed by the parties in the security financial collateral arrangement, and
(b) the parties have agreed in the security financial collateral arrangement on the valuation of the financial instruments

3. Member States which do not allow appropriation on 27 June 2002 are not obliged to recognise it. If they make use of this option, Member States shall inform the Commission which in turn shall inform the other Member States thereof

4 The manners of realising the financial collateral referred to in paragraph 1 shall, subject to the terms agreed in the security financial collateral arrangement, be without any requirement to the effect that.

(a) prior notice of the intention to realise must have been given,
(b) the terms of the realisation be approved by any court, public officer or other person,
(c) the realisation be conducted by public auction or in any other prescribed manner, or
(d) any additional time period must have elapsed

5 Member States shall ensure that a financial collateral arrangement can take effect in accordance with its terms notwithstanding the commencement or continuation

139 See also recitals 5, 14, 15 and 17 and Articles 2(1)(l) and 2(1)(n) of the CD. See sections 2 and 3 of chapter V for a further discussion of the manner of enforcement

of winding-up proceedings or reorganisation measures in respect of the collateral provider or collateral taker

6 This Article and Articles 5 [relating to the right of use of financial collateral under security financial collateral arrangements, TK], 6 [relating to the recognition of title transfer financial collateral arrangements, TK] and 7 [relating to the recognition of close-out netting provisions, TK] shall be without prejudice to any requirements under national law to the effect that the realisation or valuation of financial collateral and the calculation of the relevant financial obligations must be conducted in a commercially reasonable manner

One of the key issues in security law is the valuation of the assets, which are the object of recovery. National laws usually set out rather strict procedures in order to prevent abuse and to guarantee maximum proceeds from such assets. These procedures are designed to protect the collateral provider and, particularly in insolvency situations, the other creditors of the collateral provider. Such procedures may, for example, envisage a prior notice of the intention to enforce a security interest, a prescribed sale in the form of a public sale or a sale subject to approval by a court, and a prohibition to appropriate encumbered assets.

The Collateral Directive, however, does not lay down such strict procedures and even prohibits them in Article 4(4). What justifies this deviation from the traditional approach which protects the interests of the collateral provider and his creditors? In this respect in particular the text of recital 17 of the Collateral Directive is informative:

This Directive provides for rapid and non-formalistic enforcement procedures in order to safeguard financial stability and limit contagion effects in case of a default of a party to a financial collateral arrangement. However, this Directive balances the latter objectives with the protection of the collateral provider and third parties by explicitly confirming the possibility for Member States to keep or introduce in their national legislation an a posteriori control which the Courts can exercise in relation to the realisation or valuation of financial collateral and the calculation of the relevant financial obligations. Such control should allow for the judicial authorities to verify that the realisation or valuation has been conducted in a commercially reasonable manner

Rapid enforcement guarantees the continued availability of financial collateral and thus the liquidity of the markets. Rapid enforcement limits contagion effects and thus systemic risk. In addition to the enhancement of market liquidity, there are two other factors which justify deviation from the traditionally strict approach. First, the market participants to whom the Collateral Directive applies are, as a rule, professional players who are equally powerful and may therefore be expected to agree on a

reasonable valuation mechanism. Second, the Collateral Directive states that national legislators may determine that enforcement should be conducted in a commercially reasonable manner.¹⁴⁰

One wonders, however, whether the liberal enforcement regime envisaged in the Collateral Directive leads to a desirable result in all circumstances. The prohibition of appropriation and strict enforcement procedures are intended to protect the interests of collateral providers, who are in need of credit, against often more powerful providers of credit/collateral takers. Now that the Collateral Directive is applicable to a wide range of entities, including relatively weak small and medium-sized enterprises, the enforcement regime envisaged in the directive could favour their more powerful major counterparties in the collateral market too much. It is open to question whether an *a posteriori* control relating to the enforcement of assets by a judge is a sufficient safeguard.

In light of this imbalance, the inclusion of small and medium-sized enterprises seems inappropriate. Such enterprises play a limited role in the liquidity of the cash and securities markets. They are also less powerful than the major market participants, who can determine on what basis valuation will take place. Small and medium-sized enterprises deserve a certain level of protection. For these reasons, the applicability of the Collateral Directive should, arguably, be limited to transactions between major market participants which actually enhance the liquidity of the cash and securities markets.¹⁴¹ The issue of the liberal enforcement of security interests is discussed further in section 2 of chapter V; the issue of the limitation of the scope of the Collateral Directive in chapter VI.

Note that Article 4(3) of the Collateral Directive offers a third way of 'opting out'. Upon the occurrence of an enforcement event, financial instruments can be sold or appropriated.¹⁴² Member States that do not permit appropriation, however, are not obliged to recognize the appropriation technique in respect of financial collateral. This opt-out provision has been included because 'this technique is unknown in some Member States and it was feared that its introduction solely in respect of financial collateral arrangements could give rise to legal uncertainty in those parts

140 On this latter issue see recital 17 and Article 4(6) of the CD

141 On this issue see the Opinion of the Economic and Social Committee, the Common Position, p 21 (bottom of page), the Recommendation for the Second Reading, pp 7-8, and (on behalf of the major market participants) the ISDA Statement of Position

142 See Articles 4(1) and 4(2) of the CD

of the Community where it has never been used'.¹⁴³ The Netherlands, the United Kingdom and Germany have not made use of this possibility of opting out.¹⁴⁴

8.7.3 Title transfers: close-out netting

Article 7 of the Collateral Directive relates to the recognition of close-out netting provisions and states:

1. Member States shall ensure that a close-out netting provision can take effect in accordance with its terms:
 - (a) notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of the collateral provider and/or the collateral taker; and/or
 - (b) notwithstanding any purported assignment, judicial or other attachment or other disposition of or in respect of such rights.
2. Member States shall ensure that the operation of a close-out netting provision may not be subject to any of the requirements that are mentioned in Article 4(4), unless otherwise agreed by the parties.

Article 7 relates to the enforceability of close-out netting provisions, which usually occur in title transfer financial collateral arrangements. Contractual close-out netting provisions become effective upon the occurrence of an enforcement event, such as insolvency. Close-out netting is usually effectuated in three stages: (1) early termination of the contractual relationship between the parties and the acceleration of all obligations thereunder, (2) valuation of these obligations (and, if necessary, conversion of all cash sums due into a single currency) and (3) subsequent set-off, resulting in a single amount payable by one of the parties.¹⁴⁵ Contractual close-out netting is generally enforceable under Article 7 of the Collateral Directive. Some issues, however, must still be determined under national law. This is true for the questions of whether obligations are reciprocal and similar (and thus eligible for set-off), whether they can be netted in light of rules on voidable preference (*actio pauliana*), and in determining

143 See the Common Position, p. 23 ('5. Enforcement – Article 4').

144 For Dutch law, see subsections 1(a) and 3 of Article 7:54 of the NCC; for UK law, Regulations 17 and 18 of the Financial Collateral Arrangements (No. 2) Regulations 2003; and for German law, § 1259 of the GCC (to which provision also § 1279 and § 1295 of the GCC refer).

145 See also section 4.7 above.

the moment at which valuation should take place.¹⁴⁶ The issue of close-out netting is discussed further in section 3 of chapter V.

8.8 Insolvency law

8.8.1 Introduction

The Collateral Directive contains a number of important provisions relating to insolvency law. It prohibits the retroactive effect of a declaration of insolvency. It also allows a level of protection in respect of legal acts concluded after the moment of the declaration of insolvency. In addition, when financial collateral is enforced it does not allow the application of a freeze period that might otherwise be applicable under national law. A comparable approach was already envisaged in the Settlement Finality Directive in 1998. This section discusses the three issues mentioned in more detail.¹⁴⁷

A brief remark on the use of terminology will precede the discussion of the substantive insolvency law provisions. The Collateral Directive distinguishes between 'reorganisation measures' and 'winding-up proceedings'. Reorganisation measures are defined as 'measures which involve any intervention by administrative or judicial authorities which are intended to preserve or restore the financial situation and which affect pre-existing rights of third parties, including but not limited to measures involving a suspension of payments, suspension of enforcement measures or reduction of claims'. Winding-up proceedings are 'collective proceedings involving realisation of the assets and distribution of the proceeds among the creditors, shareholders or members as appropriate, which involve any intervention by administrative or judicial authorities, including where the collective proceedings are terminated by a composition or other analogous measure, whether or not they are founded on insolvency or are voluntary or compulsory'. In this study the collective term 'insolvency proceedings' is used to refer to both reorganisation measures (such as the Dutch *surséance van betaling*) and winding-up proceedings (such as the Dutch *faillissement*) that may apply in a state of insolvency.

146 See, in particular, recital 15 of the CD.

147 The issue of voidable preference (such as the Dutch *actio pauliana*) has not been addressed because Article 8(4) of the CD states that national rules in this respect are not affected by the directive.

8.8.2 *The declaration of insolvency has no retroactive effect*

The Collateral Directive prohibits the retroactive effect of a declaration of insolvency in relation to transactions involving financial collateral. Article 8(1)(a) states:

Member States shall ensure that a financial collateral arrangement, as well as the provision of financial collateral under such arrangement, may not be declared invalid or void or be reversed on the sole basis that the financial collateral arrangement has come into existence, or the financial collateral has been provided [...] on the day of the commencement of winding-up proceedings or reorganisation measures, but prior to the order or decree making that commencement

The result of this provision is that transfers of cash or securities that are made on the day of the declaration of insolvency, but before the actual moment of that declaration, are enforceable.¹⁴⁸ A comparable approach was already envisaged in Articles 3, 6(1) and 7 of the Settlement Finality Directive.

8.8.3 *Protection after the declaration of insolvency*

Under Article 8(2) of the Collateral Directive, legal acts relating to financial collateral that have been concluded on the day of the declaration of insolvency, but after the moment of that declaration, are enforceable if the collateral taker can prove that he was not aware and should not have been aware of the commencement of insolvency proceedings. The text of Article 8(2) of the Collateral Directive reads as follows:

Member States shall ensure that where a financial collateral arrangement or a relevant financial obligation has come into existence, or financial collateral has been provided on the day of, but after the moment of the commencement of, winding-up proceedings or reorganisation measures, it shall be legally enforceable and binding on third parties if the collateral taker can prove that he was not aware, nor should have been aware, of the commencement of such proceedings or measures.

A comparable provision was already envisaged in Article 3(1) of the Settlement Finality Directive in 1998.

148 See also Article 8(3) of the CD for a comparable provision relating to transfers of securities under margin maintenance or substitution arrangements, a provision which was discussed in sections 8.5 and 8.6 above.

8.8.4 *No freeze period*

The fact that financial collateral can be enforced irrespective of a freeze period that may normally be applicable under national law follows from Articles 4(4)(d), 4(5), 7(1)(a) and 7(2) of the Collateral Directive, which were cited above in section 8.7. According to these provisions the commencement or continuation of insolvency proceedings may not be an impediment to the immediate enforcement of financial collateral, whether provided on the basis of a security interest or by way of a title transfer. It should be possible to enforce rights in respect of financial collateral without any requirement to the effect that 'any additional time period' (e.g. a freeze period) must have elapsed. Article 9(1) of the Settlement Finality Directive sets out a comparable provision.

8.8.5 *The favourable position of the collateral taker*

The insolvency provisions of the Collateral Directive mentioned above all favour the collateral taker under a financial collateral arrangement. If the collateral taker has received financial collateral from a counterparty on the day of the insolvency of that counterparty, but before the insolvency was declared, the collateral taker may keep such collateral. The collateral taker enjoys a certain level of protection in the case of legal acts concluded after the insolvency of his counterparty, provided that he was not aware, nor should have been aware, of that insolvency. In addition, a collateral taker can enforce financial collateral without having to take a possibly applicable freeze period into account. The strong position of a collateral taker under a financial collateral arrangement has repercussions for the position of other creditors of the insolvent estate. The topic of insolvency law is discussed further in sections 4 and 5 of chapter V.

8.9 Conclusion

The European Collateral Directive is a legislative initiative that is intended to enhance the liquidity of the European markets for cash and securities by harmonising a number of provisions of property and insolvency law. The directive only relates to transactions involving financial collateral (cash and securities). The Collateral Directive relates primarily to major participants in the financial markets, but can also be applied to transactions involving small or medium-sized enterprises.

The Collateral Directive contains several provisions in relation to the provision of financial collateral both at the outset and in the course of a transaction. As far as the method of title transfer is concerned, the directive makes clear that such transfers should not run the risk of being recharacterised as security interests. In respect of the security interest method, the Collateral Directive envisages the possibility of conferring an unlimited right of disposal, a 'right of use' upon the collateral taker. In addition, the Collateral Directive protects the provision of margin collateral and substitution arrangements.

As far as the enforcement regime envisaged in the Collateral Directive is concerned, it is possible to make a distinction between the provisions of the directive relating to the enforcement of security interests and close-out netting, and provisions relating specifically to insolvency law.

The Collateral Directive sets out a liberal regime for the enforcement of a security interest in respect of financial collateral. Strict national regulations aimed at preventing abuse and guaranteeing maximum proceeds in the event of the enforcement of security interests (thereby protecting the collateral provider and his creditors) should only be relaxed if there are good reasons for doing so. The liberal regime in respect of the enforcement of financial collateral envisaged in the Collateral Directive is justified in the case of major market participants. It guarantees the continued liquidity of the cash and securities markets and limits systemic risk. Furthermore, the valuation of financial collateral is likely to be reasonable when transactions with financial collateral are entered into primarily by major market participants who are equally powerful. Moreover, the Collateral Directive allows for an *a posteriori* check on the commercial validity of the valuation of financial collateral. If financial collateral is provided on the basis of a title transfer, the enforcement of such collateral usually takes place on the basis of contractual close-out netting provisions. The Collateral Directive generally sanctions the enforceability of such close-out netting.

In the field of insolvency law, the Collateral Directive contains provisions that state that a declaration of insolvency should not have retroactive effect in the case of collateralised transactions, that allow, under certain circumstances, the enforceability of legal acts concluded by an insolvent entity even after the declaration of insolvency, and that prohibit the applicability of a freeze period when financial collateral is enforced.

There are two ways to limit the scope of the Collateral Directive. First, it is possible to apply the directive only to major market participants. Small and medium-sized enterprises can be excluded from the scope of the Collateral Directive. A number of arguments against their inclusion can be made, such as their subordinate role in the liquidity of the cash and securities markets, and the level of protection they deserve against major, more powerful market participants. A second way of setting a limit on the scope of the Collateral Directive is by applying it only to financial products that meet a dual function requirement (recovery and tradeability). Should security interest structures and fiduciary arrangements, which are entered into for recovery purposes only, fall outside the scope of the Collateral Directive? This approach would conform to the structure of the standard documentation currently in use by the markets and would be consistent with the function of collateralised transactions in enhancing the liquidity of the cash and securities markets.

9. IMPLEMENTATION OF THE COLLATERAL DIRECTIVE IN THE NETHERLANDS

9.1 Introduction

In the Netherlands, the Collateral Directive has been implemented by the Law implementing Directive 2002/47/EC on financial collateral arrangements (hereafter, the 'Dutch implementing law').¹⁴⁹ On the basis of the Dutch implementing law, several provisions have been added to Book 7 of the Netherlands Civil Code (NCC), and to the Netherlands Bankruptcy Code (NBC). The most important of these provisions are outlined in this section. A more comprehensive legal analysis can be found in chapters III, IV and V.^{150 151}

149 See *Staatsblad* 2006, 15 and *Staatsblad* 2006, 16

150 The implementation of the Collateral Directive in Dutch law has given rise to debate. See the parliamentary history in respect of the Dutch implementing law. See also Lunsingh Scheurleer 2002, Rank 2002, Keijser 2003 I, Dalhuisen / Van Setten 2003, Keijser / Verdaas 2003, Raijmakers / Van Beek 2003, Keijser 2003 II, De Serière 2004, Keijser 2004, Westrik 2004 I, Van Erp 2004 II, Westrik 2004 II, Meulman 2005, Van Erp 2005, Lieveise / Wiggers-Rust 2005, Verstijlen 2005, Silverentand 2005, Snijders 2005, Van Vliet 2005

151 Since this book does not address issues of private international law, Article 7:56 of the NCC, which lays down conflict of law rules in relation to book-entry securities, is not discussed in this section

9.2 General remarks

9.2.1 Some definitions

On the basis of financial collateral arrangements, parties intend to provide each other with money and/or securities on a temporary basis. Like the Collateral Directive, the Dutch implementing law also distinguishes between title transfer financial collateral arrangements (*financiële zekerheidsovereenkomst tot overdracht*) and security financial collateral arrangements (*financiële zekerheidsovereenkomst tot vestiging van een pandrecht*).¹⁵²

In order for a title transfer or security interest to fall within the scope of the Dutch implementing law, it must relate to money and/or securities, i.e. financial collateral. Money transferred or encumbered must be credited to an account or on a deposit. Cash in hand falls outside the scope of the implementing law. Securities should be tradable on the capital markets. For example, shares in a limited joint stock company (*besloten vennootschap*) will usually fall outside the scope of the implementing law because of a mandatory 'blockade' regulation that prevents shareholders from selling shares freely on the market.¹⁵³ The same holds true for other securities that are not traded on a market.¹⁵⁴

9.2.2 Scope of applicability

Originally, the Dutch government was in favour of a particularly broad scope of applicability *ratio personae* of the implementing law. The only limitation envisaged by the government was that the implementing law should not be applied to private individuals. It envisaged the application of the implementing law not only amongst financial institutions themselves, but also concerning financial collateral arrangements between financial institutions and enterprises, and enterprises amongst themselves. The original draft implementing law did not relate to legal entities only. Individuals who act in a professional capacity were also covered. For the applicability of the implementing law a link with the financial markets was therefore not required. The Dutch government envisaged an imple-

152 See Article 7:51(a-c) of the NCC.

153 See, however, De Serière 2004, section 5, who states that shares of a limited joint stock company are sometimes traded in the market.

154 See Article 7:51(d-e) of the NCC.

menting law with a scope broader than that of the Collateral Directive itself.¹⁵⁵

The First Chamber of the Dutch Parliament, however, did not share this point of view. It was of the opinion that the consequences of the Collateral Directive are so far-reaching that an extension of the directive's scope to transactions amongst enterprises themselves should in any case not be possible. For this reason the First Chamber rejected the government's original proposal. Consequently a new draft law had to be presented to Parliament, which came into force in January 2006. The final version of the Dutch implementing law closely follows Article 1(2)(a)-(e) of the Collateral Directive and applies to transactions amongst financial institutions themselves and to transactions between financial institutions and other enterprises.¹⁵⁶

9.3 Title transfer and right of use

9.3.1 *Title transfers*

For the sake of clarity, Article 7:55 of the NCC states that Article 3:84(3) of the NCC, which prohibits fiduciary transfers of title, does not apply to title transfer financial collateral arrangements. In addition, Article 7:55 of the NCC states that the provisions of pledge law may not be applied by way of analogy to title transfer financial collateral arrangements.

According to the Explanatory Comments, Article 7:55 of the NCC is actually superfluous. Still, Article 7:55 raises an important issue of interpretation. As in the case of the Collateral Directive itself, one could ask what the scope of the term 'title transfer financial collateral arrangement' exactly is. In order to limit the negative consequences of the Dutch implementing law for those in a weaker position, this term should, arguably, only relate to title transfers in which both recovery and tradeability functions are envisaged (and which, as such, substantially enhance liquidity),

155 The first proposal for a Dutch implementing law was given the parliamentary number 28 874

156 The second proposal for a Dutch implementing law was given the parliamentary number 30 138 For more information on the entities to which the Dutch implementing law applies, see Article 7:52 of the NCC

and not to fiduciary transfers of title in which only the recovery function plays a role.¹⁵⁷

9.3.2 *Right of use*

An important provision is Article 7:53 of the NCC, which envisages the so-called 'right of use' for a pledgee. According to this provision, this right of use means that a pledgee can be given an unlimited right to 'use or sell' (*'gebruiken of verkopen'*) the pledged assets. This phrasing is somewhat misleading. It is clearly the case that the legislator intended to give the pledgee an unlimited right of disposal. If a right of use has been granted, the pledge is allowed to sell the pledged assets, or to encumber them with a limited right.

If the pledgee disposes of the pledged assets, he may keep the proceeds. He is under an obligation, though, to transfer equivalent assets to the pledgor at the end of the transaction at the very latest. The term 'equivalent assets' has been elaborated in Article 7:51(f) of the NCC. Where cash is involved, the same amount of cash should be paid in the same currency. Securities are equivalent if they are from the same issuing institution or debtor, of the same emission or category, of the same nominal value, in the same currency and of the same kind. These equivalent assets automatically fall under the right of pledge (a kind of substitution).

An important issue of interpretation that arises in connection with the Collateral Directive and the Dutch implementing law is the scope of the term 'financial collateral arrangement' as set out in Article 7:51(a-c) of the NCC. In order to protect those in a weaker position arguably only a pledge combined with a right of use should fall within the scope of these legislative instruments, whereas a pledge without a general right of disposal should not, as it has hardly any impact on liquidity.

9.4 **Enforcement**

9.4.1 *Enforcement of a right of pledge*

Article 7:54 of the NCC, which relates to the enforcement of a right of pledge in respect of financial collateral, is an important deviation from the

157 For more on the issue of interpretation, see in particular section 3 of chapter VI below.

standard enforcement procedure of a right of pledge. If an event of default as defined in Article 7:51(g) of the NCC occurs, the enforcement of a right of pledge in respect of cash or securities can take place as follows. Securities can be enforced by way of (a) a sale and recourse to the proceeds, or (b) appropriation. In the case of a sale, the securities should be sold by an intermediary in a market or on an exchange – under certain circumstances even by the collateral taker himself – according to the generally applicable rules governing that market or exchange. Appropriation is only possible if this has been agreed upon and if valuation is based on prices in a market or on an exchange. Cash is enforced by way of 'netting'.¹⁵⁸ The general provisions of pledge law concerning terms, notifications and the formal manner of sale (public sale, approval by a judge) are not applicable in the enforcement of a right of pledge in respect of financial collateral.

9.4.2 *Close-out netting*

If a title transfer arrangement is ended prematurely, the parties will usually want contractual close-out netting provisions to take effect. Article 7 of the Collateral Directive aims at the enforceability of such contractual provisions.¹⁵⁹ According to the Explanatory Comments to the Dutch implementing law such contractual provisions are enforceable under Articles 53 and 234 of the NBC. Consequently, the implementing law does not contain a provision which sanctions contractual close-out netting provisions.

9.4.3 *Insolvency law*

The Dutch implementing law also contains a number of amendments to the NBC. Two changes, which are set out in the new Articles 63e and 241e of the NBC, relate to the declaration of insolvency and its effects. First, as far as financial collateral arrangements are concerned, a declaration of insolvency cannot be applied retroactively (as it normally would be) to the beginning of the day of that declaration.¹⁶⁰ In connection with the

158 The Dutch implementing law and the Explanatory Comments thereto use set-off terminology when referring to the enforcement of a right of pledge in respect of cash. This is not appropriate, as a pledgee has recourse, but does not set off. For more information, see section 2.2.3 of chapter V.

159 See also section 8.7.3 above.

160 If necessary, Articles 23, 35 and 217 of the NBC will, for this reason, not be applied to financial collateral arrangements.

abolition of this so-called 'zero hour rule', the revised Articles 14 and 216 of the NBC set out an obligation for the judge to mention in each and every declaration of insolvency the exact time it has been issued. Second, the protection of contractual counterparties of an insolvent party to a collateral agreement is expanded, even after the declaration of insolvency.¹⁶¹ A third change is that, in accordance with the new Articles 63d and 241d of the NBC, the freeze period set out in Articles 63a and 241a of the NBC does not apply when a right of pledge in respect of financial collateral is enforced. Apart from that, Articles 42 *et seq.* of the NBC relating to voidable preference (the Dutch *actio pauliana*) will remain in force in line with Article 8(4) of the Collateral Directive.¹⁶²

161 This is a different approach than that of Articles 23, 24, 35, 53(1), 54(2), 217, 228, 234(1), 235(2) of the NBC and Article 3 72(a) of the NCC, which will, if necessary, not be applied in the case of a financial collateral arrangement

162 The Dutch implementing law leads to comparable changes in respect of the retroactive effect of the declaration of insolvency, the enforceability of legal acts after the declaration of insolvency and the freeze period in the Credit System Supervision Act 1992 (*Wet toezicht kredietwezen 1992*), the Insurance Undertakings Supervision Act 1993 (*Wet toezicht verzekeringsbedrijf 1993*) and the Insurance Undertakings (Benefits in Kind for Funerals) Supervision Act (*Wet toezicht natuuraanvaartverzekeringsbedrijf*) These laws will not be discussed here

TRANSFER OF TITLE

1. INTRODUCTION

1.1 Contents

This chapter deals with title transfers, which are the most commonly used method of providing financial collateral in repurchase and securities lending transactions. In a title transfer, a party transfers all right, title and interest in respect of financial collateral to a transferee without limitations. Financial collateral can also be provided by vesting a security interest combined with a general right of disposal (a 'right of use'), which is the topic of chapter IV.

Section 2 of this chapter considers the title transfer method set out in standard documentation that is used internationally. It will become apparent that market participants in the Netherlands apply different legal constructions, such as a sale or a loan of fungibles, to effect an unlimited transfer of financial collateral.

Section 3 examines the reasons why market participants choose to provide financial collateral through the title transfer method and why they are concerned about the recharacterisation of a title transfer as a security interest. Under the general principles of Dutch (and German) civil law, for instance, what are the circumstances under which the parties should choose either an outright transfer of title or the establishment of a security interest in respect of financial collateral? To answer this question, the different functions of title transfers and security interests must be examined. Recognising a clear distinction between the functions of a title transfer and a security interest provides a key to understanding the risk related to recharacterisation. This section also considers the approach of the Collateral Directive and Dutch implementing law in this respect.

Section 4 examines a second recharacterisation risk: whether a transfer of collateral under, for example, a repo or a securities lending transaction is not actually a temporary transfer of ownership. This is important because,

under Dutch law, a temporary transfer of ownership is recharacterised as a right of usufruct.

While this chapter focuses on Dutch law, some comparisons to German law have been made so as to stress the importance of the core principles of security interests outlined in the next section and to support the argument that there is an essential difference between the functions of a transfer of title and a security interest. In this chapter, American and English law research play a relatively subordinate role, except in section 3.3.3, where they are used to provide an extra illustration. American and English law are considered in more detail in chapter IV in connection with security interests combined with a general right of disposal. While the latter construction is American in origin, it meets the needs of London market participants, a factor that has contributed to its becoming part of European law.

1.2 Terminology

In this book, the term 'security interest' will be used as a general term to refer to a limited proprietary right that is established for the purpose of recovery. An example of a security interest is the Dutch right of pledge. A fiduciary transfer of title, which was recognised under old Dutch law and is currently applied under, for example, German law, is (from an economic point of view in any case) essentially a security interest. While from a strictly legal point of view, a fiduciary transfer entails a transfer of title, the powers of the transferee are limited to such an extent that, in effect, he has a security interest for the purpose of recovery only.¹ In Article 2(1)(c) of the Collateral Directive, a 'security financial collateral agreement' is defined as 'an arrangement under which a collateral provider provides financial collateral by way of security in favour of, or to, a collateral taker, and where the full ownership of the financial collateral remains with the collateral provider when the security right is established.'

Security interests are distinguished from 'outright transfers of title' or 'title transfers', terms that are generally used as synonyms to refer to the unlimited passing from one party to another of all right, title and interest in respect of an asset. In collateral markets, terminology related to title transfer is indeed commonly applied to indicate an outright transfer of title, i.e. an unlimited transfer of all right, title and interest.

1 See also section 8.3 of chapter II and sections 3.2.2 and 3.2.3 of this chapter

This is apparent in the GMRA: (1) Paragraph 6(e): 'all right, title and interest [...] shall pass to the party to which transfer is being made'; (2) Page 10 of the Guidance Notes to the GMRA: 'All transfers of securities [...] pass absolute title to those securities to the transferee'; (3) Paragraph 6(f): 'Notwithstanding the use of expressions such as "Repurchase Date", "Repurchase Price", "margin", "Net Margin", "Margin Ratio" and "substitution", which are used to reflect terminology used in the market for transactions of the kind provided for in this Agreement, all right, title and interest in and to Securities and money transferred or paid under this Agreement shall pass to the transferee upon transfer or payment [...]', which makes clear that in the case of a transfer of securities under the GMRA – notwithstanding the use of market terminology that points in the direction of a continuous proprietary interest of the transferor – all right, title and interest pass to the transferee.

The GMSLA also applies title transfer terminology to indicate an outright transfer. See, for example: (1) Paragraph 4.2: 'all right, title and interest [...] shall pass from one Party to the other [...] with full title guarantee, free from all liens, charges and encumbrances'; (2) Paragraph 2.3: 'Notwithstanding the use of expressions such as "borrow", "lend", "Collateral", "Margin", "redeliver" etc. which are used to reflect terminology used in the market for transactions of the kind provided for in this Agreement, title to Securities "borrowed" or "lent" and "Collateral" provided in accordance with this Agreement shall pass from one Party to another as provided for in this Agreement [...]', which makes clear that – notwithstanding the use of market terminology that points in the direction of a lasting proprietary interest of the transferor – the parties to the GMSLA intend a transfer of title from one party to the other.

Title transfer terminology is also used in the heading of Part 3 of the ISDA 2001 Margin Provisions ('Elective Provisions – Title Transfer Approach') and in Section 3.1 of these Margin Provisions, where it indicates that the parties intend to transfer all right, title and interest and do not intend to create a security interest.² See also Article 2(1)(b) of the Collateral Directive, which defines a 'title transfer financial collateral arrangement' as 'an arrangement, including repurchase agreements, under which a collateral provider transfers full ownership of financial collateral to a collateral

2 The text of Section 3.1 of the ISDA 2001 Margin Provisions is quoted in section 2.3 of chapter II.

taker for the purpose of securing or otherwise covering the performance of relevant obligations.'

It should, however, be noted that the term 'title transfer' is not entirely unambiguous. Often title transfers are indeed 'outright', which means that the transferee obtains all right, title and interest without limitation. However, in the context of a fiduciary relationship, this is not the case. If, for example, a transfer takes place for security purposes, such as in the case of a fiduciary transfer of title, this transfer is not outright because, even if title has been transferred, the powers of the transferee are limited to having recourse. Such a transfer is essentially a security interest (see above).³ Likewise, in a trust context, a title transfer is not outright. In this case, a distinction must be made between 'legal' title and 'equitable' or 'beneficial' title. When establishing a trust, a beneficiary transfers legal title of certain assets to his trustee, while remaining equitably entitled thereto.⁴ Therefore the term 'title transfer' does not necessarily imply an outright passing of title; it may also relate to a fiduciary relationship. In collateralised transactions, such as repo or securities lending transactions, a party generally transfers to his counterparty all right, title and interest in respect of securities or cash, without limitations. For this reason, and in conformity with the terminology applied in the markets, no sharp distinction between the terms 'outright transfer' and 'title transfer' is made here. If a transfer is of a fiduciary nature, this is explicitly stated.

The term 'transfer of ownership' is also sometimes applied in this book to indicate an unlimited outright title transfer. The term 'transfer of ownership' is not fully appropriate in the securities market. In particular, in the case of securities registered in book-entry systems, it is not the 'ownership' of securities that is transferred, but rather a claim of a proprietary or contractual nature in respect of securities.⁵ Still, in practice, the termi-

3 As was already indicated in section 8.3 of chapter II, it is not that easy to qualify a fiduciary transfer for recovery purposes as either a title transfer or a security financial collateral arrangement in the sense of Articles 2(1)(b) and 2(1)(c) of the CD. Neither does the collateral taker obtain full, unlimited ownership in the sense of Article 2(1)(b) of the CD, nor does full ownership remain with the collateral provider in the sense of Article 2(1)(c) of the CD. But, after all, it is not the label that matters but the (fiduciary) content of the arrangement. See in particular sections 3.2.2 and 3.2.3 below on the limitations of the rights of the fiduciary.

4 Cf. the term 'title' in Black's Law Dictionary, and in particular 'equitable title' and 'legal title'.

5 It has even been argued that no proprietary transfer takes place at all when a transfer order in respect of book-entry cash and/or securities is executed, but that such an act should be characterised as a mechanism *sui generis* that is comparable

nology of ownership is sometimes applied. This is evident in, for example, Articles 2(1)(b) and 2(1)(c) of the Collateral Directive (cited above) and Articles 12(c) and 13(c) of the GMSLA, which presume that the parties to this agreement are entitled to pass 'full legal and beneficial ownership'.

1.3 Core characteristics of security interests

Security interests, such as a right of pledge or a fiduciary transfer of title, traditionally have a number of essential characteristics, several of which are outlined here because they play a key role throughout chapters III, IV and V. Particular attention is given to those characteristics that shape the fiduciary relationship between collateral provider and collateral taker. A number of other core features are also mentioned, even though they play a less significant role in this study. The following list of the characteristics of security interests is not meant to be exhaustive. They are sketched briefly to serve as a point of reference and are elaborated upon in more detail later.

Under Dutch and German law, security interests, such as a right of pledge or a fiduciary transfer of title, *grosso modo* have the following characteristic features that shape the fiduciary relationship between the parties:⁶

1. The secured party has a *duty of due care* in respect of the assets in which he has a security interest. This means, for example, that he should, within reasonable limits, do his best to prevent any damage to or destruction of the encumbered assets. The duty of due care is of particular importance in the case of a possessory security interest, in which the encumbered objects are in the possession of the secured party.⁷
2. The collateral provider has a *right of redemption*. This means that he regains full title to the encumbered assets if he pays the secured debt. A right of pledge becomes void and ceases to exist once the secured debt is fulfilled. This means that from that moment, the

to novation. See, for example, Schim 2002, Van Setten in Dalhuisen / Van Setten 2003, and Schim 2004.

6 Because the fiduciary transfer of title was not codified under old Dutch law or German law, references to the NCC and the GCC in the footnotes of this section relate to the right of pledge only. Fiduciary transfers of title under old Dutch and current German law are further elaborated upon in sections 3.2.2 and 3.2.3.

7 See Articles 3:243 and 3:257 of the NCC, and §§ 1215-1217 of the GCC.

pledged asset is no longer encumbered with the right of pledge.⁸ In the case of a fiduciary transfer of title, the title either falls back automatically or should be re-transferred upon the fulfilment of the secured debt.⁹

3. A secured party has the *right to sell upon default* of his counterparty. The goal of a security interest is to create an object for recourse if a secured debt cannot be fulfilled. It is for this reason that a security interest can be exercised only in the event of default. The secured party has no right to dispose of the encumbered object under 'normal' circumstances.¹⁰
4. If a pledgee *sells* the encumbered assets upon default, he must do so *in a prescribed manner*. This usually means, for example, that he should give prior notice of his intention to sell the encumbered assets and that he is obliged to sell them in public or with the consent of a judge in order to prevent abuse and to yield maximum proceeds.¹¹ Under old Dutch law, the formal requirements relating to the enforcement of a right of pledge were, to a large extent, applied by way of analogy to fiduciary transfers of title. Under German law, the original owner and the fiduciary can themselves determine in an agreement how enforcement should take place, even though the provisions of pledge law are likely to be applied by way of analogy in the absence of such an agreement.¹²
5. The secured party is *not allowed to appropriate* the assets upon default. The prohibition of appropriation is an additional mechanism to prevent abuse and to guarantee maximum proceeds for the benefit of the collateral provider (and his creditors). Because the secured party cannot appropriate the encumbered assets, he must sell them in a transparent way and in a prescribed manner (see no. 4 above).¹³

8 See Articles 3:227 and 3:249(2) of the NCC, and § 1204, § 1223 and § 1252 of the GCC.

9 See sections 3.2.2 and 3.2.3.

10 See Article 3:248 of the NCC and § 1228 of the GCC. See sections 3.2.2 and 3.2.3 below for fiduciary transfers of title.

11 See Articles 3:249-251 of the NCC, and § 1221, §§ 1234-1240 and §§ 1245-1246 of the GCC.

12 See sections 3.2.2 and 3.2.3.

13 See Article 3:235 of the NCC and § 1229 of the GCC. See also sections 3.2.2 and 3.2.3 below.

6. Should there be any *surplus value* upon enforcement and fulfilment of the secured obligation, the secured party must pay this amount *to the collateral provider*. This reflects the fact that a security interest is meant as a safeguard to ensure that the secured debt will be fulfilled, and nothing more. Any surplus value upon enforcement must be transferred to the collateral provider, which is also in the interests of the collateral provider's other creditors.¹⁴

These characteristics, which are also referred to as 'pledge principles' in the text below, shape the fiduciary relationship between collateral provider and collateral taker through clearly defining their mutual rights and obligations. In particular, they guarantee a balance between the interests of collateral providers, their creditors, and collateral takers. This balance is generally considered to be fundamental because collateral providers who are in need of credit are in a dependent position and therefore deserve a level of protection against collateral takers. For this reason, the characteristics of security interests mentioned are also, to a large extent, issues of mandatory law. They are essentially an elaboration of the principle that parties should act in a reasonable manner towards each other. The application of the core characteristics of security interests is particularly important in a situation in which there is no equal balance of power between the provider of credit and his debtor, who provides an object for recovery.

Security interests also have a number of other characteristic features, which play a less important role in this study because they are not primarily aimed at shaping the fiduciary relationship between collateral provider and collateral taker. As far as the Dutch right of pledge is concerned, the following features may be mentioned:¹⁵

7. The absolute character of the right of pledge, i.e. its enforceability against third parties also.
8. The right of pledge is vested in the encumbered assets, even if those assets have been transferred to a third party (*droit de suite, zaaksgesvolg*).

14 See Article 3:253 of the NCC and § 1247 of the GCC. See also sections 3.2.2 and 3.2.3 below.

15 The German right of pledge and the fiduciary transfer of title under old Dutch and current German law differ in a number of respects. These differences are not discussed here.

9. The accessory relationship between a right of pledge and the secured debt, which implies, for example, that the right of pledge ceases to exist when the secured debt is fulfilled (see also no. 2 above) and that the right of pledge follows the secured debt when it is assigned to a third party, i.e. the third party then becomes entitled to the right of pledge.
10. In the event of default, a pledgee is entitled to enforce his right of pledge without a prior judicial writ authorizing enforcement (*recht van parate executie*), and to separate assets from those of an insolvent entity. Moreover, the pledgee has a preferential position in relation to other creditors (*voorrang*).¹⁶

2. TRANSFER OF TITLE: THE MARKET APPROACH

2.1 Introduction

A number of important standard agreements used within and outside Europe envisage the transfer of title for financial collateral (see section 2.2 below). In Dutch practice, collateral is also customarily provided on the basis of an outright transfer of title in the course of repos and securities lending transactions. Sections 2.3–2.5 examine the different legal *causae* (*titels*) used by Dutch market participants on which they base the transfer of title for financial collateral at the outset and at the end of a repo or securities lending transaction. Sections 2.6 and 2.7 pay particular attention to transfers of financial collateral in the course of such transactions under margin and substitution arrangements.

2.2 The approach of the standard documentation

Under the common standard agreements used to document repo and securities lending transactions within and outside Europe, financial collateral is provided on the basis of a title transfer.¹⁷

¹⁶ For more information about security interests under Dutch law, see, for example, Van Mierlo 1988 (fiduciary transfers of title); Pitlo / Reehuis, Heisterkamp 2001, chapter 14.1–4 (pledge law). For security interests under German law, refer to, e.g., Baur / Stürner 1999, §§ 55–59; Serick 1990; Strothmann 1995; Jäkel 2001.

¹⁷ See section 3 of chapter II for an overview of the different standard agreements. For the title transfer method, see also sections 2.3 and 2.4 of chapter II and section 1.2 on terminology above.

In the case of repos, the Global Master Repurchase Agreement (GMRA) envisages a title transfer method of providing financial collateral. It does so in relation to financial collateral provided on the basis of a sale at the outset and at the end of a transaction (see Paragraphs 1(a), 3(c) and 3(f) of the GMRA), in respect of margin securities (see Paragraph 4 of the GMRA) and in the event of substitution (see Paragraph 8 of the GMRA). Paragraph 6 of the GMRA on 'Payment and Transfer' is the key provision that makes it clear that transfers of these types of financial collateral are outright, whether at the outset, in the course or at the end of a transaction. In particular, subsections (e) and (f) of this provision make it clear that 'all right, title and interest' pass to the transferee in the case of a transfer of cash or securities under the GMRA.

In the case of securities lending transactions documented under the Global Master Securities Lending Agreement (GMSLA), the approach is essentially the same. Under the GMSLA, financial collateral is transferred at the outset and at the end of a transaction, as well as in margin and substitution arrangements (see Paragraphs 1.1, 5 and 8 of the GMSLA). Paragraphs 2.3 and 4 of the GMSLA make clear that such transfers are outright, i.e. that in these cases, all right, title and interest pass to the transferee.

In the case of repos documented under the European Master Agreement (EMA), transfers of financial collateral are similarly outright, including payments under margin and substitution arrangements.¹⁸ The same approach is taken in the EMA where transfers of financial collateral under securities lending transactions are concerned, including transfers of cash or securities as margin.¹⁹

2.3 Repos under Dutch law

Participants in the Dutch repo market follow the title transfer approach set out in standard agreements such as the GMRA and the EMA. Under Dutch law, the transfer of title for financial collateral at the outset and at

18 See Section 3(2) of the EMA General Provisions in connection with the EMA Product Annex for Repurchase Transactions and the EMA Margin Maintenance Annex

19 See Section 3(2) of the EMA General Provisions in connection with the EMA Product Annex for Securities Loans and the EMA Margin Maintenance Annex. Note that, whereas Section 3 of the Product Annex for Repurchase Transactions relates to substitution, the Product Annex for Securities Loans contains no comparable provision. See also section 4.4 on substitution, in chapter II

the end of repurchase transactions is based on two sale agreements. This section relates to these transfers and does not consider flows of cash and securities arising in the course of a transaction.²⁰

Graphically, the legal structure of a repo transaction under Dutch law can be represented as follows:

At the outset of a transaction (at moment T), a seller and a buyer conclude a sale agreement. On the basis of this agreement, the seller delivers securities to the buyer for an amount of cash. Under Dutch law, the combination of a valid title or *causa* (the sale agreement) and a formal act of delivery results in an outright transfer of title, if the party who intends to transfer assets is entitled to dispose of them.

At the same moment T, the parties agree that the buyer must transfer equivalent securities to the seller in exchange for an amount of cash at the end of the transaction at moment T+X. This second transfer of financial collateral, too, can only be effected on the basis of a valid *causa* (i.e. in this case a second sale agreement) combined with an act of delivery by a party who is entitled to dispose of that collateral. A second sale agreement is therefore necessary as a basis for the transfer of financial collateral at the end of the transaction. This second sale agreement can be concluded at moment T, which is common practice in the Netherlands.²¹ Alternatively, at moment T the parties can agree upon an obligation to conclude a sale

²⁰ See section 4 of chapter II for a more detailed description of the flows of cash and securities in a repo transaction. The *causae* of transfers of financial collateral under margin and substitution arrangements are considered in sections 2.6 and 2.7 below.

²¹ See, for example, Rank 1998 II, p. 372, who states that there is a transfer of assets based on a sale agreement at moment T, with a simultaneous sale agreement that serves as a basis for the transfer of equivalent assets at T+X.

agreement at moment T+X. In this latter case, one could speak of a pre-sale agreement at moment T.²² The moment that the actual sale agreement is concluded can be shaped according to the wishes of the parties. All in all, it is not that important to establish the moment that the sale agreement is concluded because the transfer of financial collateral at T+X is definite only when the sale agreement has been completed by an act of delivery by a party who is entitled to dispose of the collateral involved.²³

2.4 Securities lending under Dutch law

2.4.1 Market practice

This section deals with transfers of financial collateral at the outset and at the end of a securities lending transaction. At the outset of a securities lending transaction, a lender provides securities to a borrower in exchange for collateral in the form of cash or securities. At the end of the transaction, the lender receives equivalent securities and is obliged to transfer equivalent collateral assets to the borrower. This section relates to the *causae* of the transfers at the outset and end of a transaction and does not consider flows of cash and securities occurring in the course of it.²⁴

In securities lending transactions, a distinction must be made between the *causa* of the transfer of the lent securities and that of the collateral securities. In a securities lending transaction under Dutch law, the lent securities are customarily transferred on the basis of a loan of fungibles (*verbruiklening*). It should be noted, however, that in practice, different means of providing collateral are used, as they can be provided on the basis of a loan of fungibles, a sale or exchange agreement, or a pledge. These are considered in more detail below.²⁵

22 In this respect, see, for example, Paragraph 1(a) of the GMRA, which mentions a 'simultaneous agreement [] to sell [] at a date certain or on demand', which seems to point in the direction of an actual sale at moment T+X

23 See Schroeder 1997, section 3.2, Rank 1998 I, pp. 17-20; Rank 1998 II, pp. 372-377

24 See section 4 of chapter II for a more detailed description of the flows of cash and securities in a securities lending transaction. The *causae* of transfers of financial collateral under margin and substitution arrangements are considered in sections 2.6 and 2.7 below

25 See Van Ardenne-Stachiw 1995, in particular chapter 2, Rank / Van Ardenne-Stachiw / Le Rütte 1996, pp. 9-11, Schroeder 1997, section 3.1, Rank 1998 I, pp. 21-22, Rank 1998 II, pp. 379-380

a. Option 1: loan of fungibles

The first option would be to transfer the lent securities on the basis of a loan of fungibles, and the collateral cash and/or securities on the basis of a 'counter'-loan of fungibles. Graphically, the structure of such a securities lending transaction can be represented as follows:

When a borrower is in need of particular securities, the lender can transfer these securities to him at moment T on the basis of a loan of fungibles. Such a transfer is outright, because a loan of fungibles entails an outright transfer (see section 2.4.2). This means that the borrower has the right to dispose of the securities provided as he pleases during the entire course of the transaction. The loan of fungibles only gives rise to an obligation to transfer equivalent securities to the lender at the end of the transaction, at moment T+X.

At the same time, the lender does not want to be unsecured and, moreover, would like to be able to dispose of any collateral received from the borrower. To this end, the parties enter into a 'counter'-loan of fungibles. The borrower 'lends' financial collateral consisting of securities and/or cash to the lender at moment T. Because a loan of fungibles entails an outright transfer (see section 2.4.2), the lender is entitled to dispose of the collateral received during the course of the transaction, but is also under an obligation to transfer equivalent collateral to the borrower at the end of the transaction, at T+X.

b. *Option 2: sale / exchange agreement*

In the second option, the lent securities are again transferred by the lender to the borrower on the basis of a loan of fungibles. This means that the borrower is entitled to dispose of the securities transferred, but is obliged to transfer equivalent assets at the end of the transaction. In this case, however, the collateral securities and/or cash are transferred by the borrower to the lender at the outset of the transaction on the basis of a sale or an exchange agreement. Under Dutch law, a sale agreement should be concluded if the sale price is paid in cash.²⁶ If the exchange value is different (e.g., securities), an exchange agreement is appropriate.²⁷ The exchange agreement has been regulated in Articles 7:49-50 of the NCC and – like the sale agreement – leads to an outright transfer of assets if combined with an act of delivery by a party entitled to dispose of the assets concerned.²⁸ Note that in this case, the parties agree that the sale price or the assets exchanged will only be provided by the lender at the end of the transaction in the form of equivalent securities and/or cash.

26 See the definition of a sale agreement in Article 7:1 of the NCC.

27 See the definition of an exchange agreement in Article 7:49 of the NCC. The text of this provision relates to physical assets (*zaken*) only, but the Explanatory Comments to Article 7:49 of the NCC make it clear that an exchange can relate to assets (*goederen*) in general, i.e. to securities as well. See Parliamentary History of the NCC, *Boek 7; Bijzondere Overeenkomsten*, pp. 299-300.

28 The provisions of the NCC concerning the agreement of sale apply to exchange agreements by way of analogy.

This structure, consisting of transfers based on a loan of fungibles and a sale or an exchange agreement, is comparable to the first structure (which was based on a loan of fungibles and a 'counter'-loan of fungibles). In both cases, the lent securities and the collateral cash and/or securities are transferred outright, which means that both the borrower and the lender have an unlimited right of disposal in respect of the assets that they have received at the outset of the transaction. Moreover, the parties are under an obligation to transfer equivalent assets at the end of the transaction.

c. *Option 3: pledge*

In the third scenario, the lent securities are also transferred at the outset of the transaction by the lender to the borrower on the basis of a loan of fungibles. But in this case, the borrower does not transfer collateral securities and/or cash to the lender; rather, he establishes a right of pledge in such collateral for the benefit of the lender. At the end of the transaction, the borrower transfers equivalent securities to the lender. At that same moment, the right of pledge is terminated because the secured obligation is fulfilled.

The major difference between this structure and the first two is that the lender has no unlimited right of disposal in respect of the collateral provided by the borrower. The lender has a right to dispose only in the event of default, and not in the normal course of business. When the borrower fulfils his obligation under the loan of fungibles contract and transfers equivalent securities to the lender at the end of the transaction, the right

of pledge is terminated as well. The borrower is again fully entitled to exactly the same assets to which he had established a right of pledge at the outset of the transaction.

It should be noted that with the introduction of the Collateral Directive, the collateral taker (the lender) can be granted a so-called 'right of use', i.e. the right to dispose of pledged assets in the course of the transaction. The issue of a right of use is discussed further in chapter IV. Chapter VI discusses the question of whether transactions in which a traditional right of pledge (without a general right of disposal) has been established, fall within the scope of the Collateral Directive.

2.4.2 *A loan of fungibles: transfer of ownership*

The loan of fungibles (*verbruiklening*, *Sachdarlehen*) has been regulated under Dutch law in Articles 7A:1791-1806 of the NCC and under German law in §§ 607-609 of the GCC. Under both Dutch and German law, a loan of fungibles entails a transfer of ownership.²⁹ In the case of a loan of fungibles, the reason for passing ownership from one party to another is based on the concept of replaceability. In the case of a loan of fungibles, the lender makes assets replaceable when he grants the borrower the right to dispose of the lent fungibles, while the borrower consents to an obligation to transfer equivalent assets to the lender at a later date. These two features (i.e. the right of disposal combined with an obligation to transfer equivalent assets) make assets replaceable. This concept, which entails a passing of ownership, plays a role in a number of legal structures in civil law. In addition to in the loan of fungibles, the irregular structures discussed more in-depth in chapter IV (the irregular right of pledge, the irregular right of usufruct and an irregular custody arrangement) also show that, in principle, a passing of ownership takes place when assets are made replaceable.³⁰

29 For Dutch law, see Asser Series 5-IV, chapter III, Pabbruwe 1979, Van Ardenne-Stachuw 1995, chapter 2. For the recently revised German law, see the Palandt Commentary, 64th edition, pp 870-871. For old German law, see the Münch Commentary, volume 4, 3rd edition, p 8, no 5, for a special analysis of securities lending, see the Soergel Commentary, volume 4/1, 12th edition, pp 1415-1416, no 37.

30 See chapter IV, in particular section 4.6

2.5 The different legal structures of repo and securities lending transactions

Economically and structurally, repo and securities lending arrangements are very similar. The only difference is that a repo transaction is usually entered into because the seller is in need of cash, while a securities lending transaction is normally entered into because the borrower needs a particular kind of security. Otherwise, the economic rationale (obtaining liquidity in the form of cash or securities) and the structure of repos and securities lending transactions (consisting of two 'legs' that are activated at moment T and at moment T+X) are to a large extent the same. In Dutch practice, however, the *causa* is different for financial collateral transferred under repo and securities lending transactions. As was shown above, financial collateral is customarily transferred on the basis of a sale in the case of a repo transaction. In a securities lending transaction, financial collateral is usually transferred on the basis of a loan of fungibles (even though collateral may also be transferred on the basis of a sale or exchange agreement, or be pledged; see section 2.4 above).

How have these different legal structures come into existence under Dutch law? An important factor in this respect is probably the structure of international standard agreements. The sale is mentioned as the *causa* of a transfer of financial collateral as early as Paragraph 1(a) in the GMRA, whereas the GMSLA is an agreement that relates to the 'lending' of securities, with the step to a 'loan' of fungibles easy to take. Another factor is that a sale agreement, as defined in Article 7:1 of the NCC, is an agreement under which one party gives an asset for which the counterparty pays a price in money. This concept fits repurchase transactions well: in this case, securities are sold for money. But a securities lending transaction often involves an exchange of a specific type of security for other collateral securities, and not necessarily the payment of a price in money. The sale concept, therefore, does not fit such transactions, and this necessitates another *causa*, i.e. an exchange agreement, or a loan of fungibles.³¹

All in all, it does not really seem to matter how financial collateral is transferred, whether on the basis of a sale or an exchange agreement, or on the basis of a loan of fungibles. The economic rationale of repurchase and securities lending transactions can be realised by applying any of the above. An outright transfer of title can be based on a sale or an exchange

31 Cf. Van Ardenne-Stachiw 1995, section 2.6.

agreement, or on a loan of fungibles. In all cases, the effect is that both parties have the right to dispose of the assets transferred during the entire course of the transaction. In addition, the parties to both repurchase and securities lending transactions are obliged to deliver equivalent cash and securities at the end of the transaction. In a repurchase transaction, this obligation follows from a second sale agreement. In the case of a securities lending transaction, the obligation to transfer equivalent assets arises for the borrower in connection with the initial loan of fungibles, whereas for the lender (depending on the structure chosen by the parties for the provision of collateral) it is in connection with, for example, a second loan of fungibles or a loan or exchange agreement.

2.6 Margin arrangements

This section relates to the provision of margin cash and/or securities under one of the methods of margin maintenance outlined in section 4.3 of chapter II. In particular, it investigates on the basis of what *causa* margin collateral is provided. The focus is on margin transfers, the most common method of margin maintenance. Some attention will also be paid to methods based on repricing and adjustment.

2.6.1 Margin transfers

The GMRA and GMSLA make it clear that margin, in the form of securities and/or cash, is transferred outright, but they do not specify what the *causa* of this transfer is.³² In this section, the functions of such margin collateral are the point of reference when determining this *causa* under Dutch law. Margin collateral is transferred in order to cover an exposure attributable to price fluctuations in the market. Margin collateral thereby serves a security function. The circumstance that *equivalent* margin should be provided at the end of a transaction shows, however, that the party who is obliged to pay margin under a GMRA or GMSLA agreement, for example, does not intend to provide security only. He also intends to grant his counterparty an unlimited right of disposal in respect of the collateral transferred, which thereby also serves a tradeability function. Under general principles of civil law, such a right of disposal can only be granted on the basis of an outright transfer of title.

32 See Paragraphs 4 and 6 of the GMRA, and Paragraphs 4 and 5 of the GMSLA.

Rank seems to feel that the *causa* of the transfer of margin collateral is an agreement aimed at security only.³³ In my view, this is not entirely correct. It is true that the reason for the transfer is a net exposure, which is meant to be eliminated by the margin collateral. But the margin collateral also serves an additional function. As stated above, the transferee of the margin collateral is also able to dispose of it. These two functions require an outright transfer that runs no risk of being recharacterised as a security interest. From this perspective, Rank's statement that margin transfers run a bigger risk of recharacterisation than transfers of cash and/or securities at the outset of a transaction is, in my view, also not convincing.³⁴ Margin collateral, like financial collateral transferred at the outset of a transaction, serves more than a security purpose. It is also meant to be traded.

Unlike Rank, Schroeder puts forth an argument that does justice to the actual intentions of the parties. Essentially, he adheres to the view that margin collateral is transferred outright. He has some difficulties, though, in establishing the *causa* of this transfer, particularly where margin transfers in repo transactions are concerned. For margin transferred in securities lending transactions, he proposes either repayment of the original loan of fungibles as a *causa*, or the establishment of a new loan of fungibles, both of which entail an outright transfer.³⁵ A simpler solution that can be applied in the case of repo, securities lending or other financial collateral arrangements is available, however.

In Dutch law, the concept of replaceability seems to take most fully into account the actual intentions of the parties. Assets are made replaceable when a party grants his counterparty in a transaction a right of disposal in respect of these assets, and if that counterparty is under an obligation to transfer equivalent assets at a later date. Replaceability entails an outright transfer, as has already been shown above in the case of a loan of fungibles³⁶ and as will also be shown below in chapter IV for the irregular right of pledge, the irregular right of usufruct and irregular custody arrangements. The *causa* of a transfer of margin collateral under Dutch law can therefore be established by referring to the concept of replaceability.

33 See Rank 1998 II, p. 404 and p. 413.

34 See Rank 1998 I, p. 26.

35 See Schroeder 1997, p. 207 and p. 211.

36 See section 2.4.2 above.

If the parties consider the provision of margin collateral for purposes of recourse only, they should establish a right of pledge.³⁷ It is questionable, however, whether margin that is provided in this way can be classified as collateral in the sense of the Collateral Directive because it does not fulfil the dual function requirement. Whether such collateral falls within or outside the scope of this directive will be discussed in chapter VI.

2.6.2 Repricing and adjustment

Repricing and adjustment are margin maintenance methods that entail the premature termination of a transaction and the conclusion of a new transaction in which price fluctuations have been taken into account.³⁸ The method applied in the case of repricing and adjustment, therefore, differs from that applied in the case of margin transfers. In this case, margin collateral is not transferred in the course of one and the same transaction by making assets replaceable; it is done by entering into a new transaction. Essentially, however, repricing and adjustment are, to a large extent, comparable to margin transfers. The goal of each of these margin maintenance methods is the elimination of exposure arising from price fluctuations in the market. In addition, in the case of repricing and adjustment, the transferee of cash and/or securities also has the right to dispose of the assets transferred and is under an obligation to transfer equivalent assets at a later date. Cash and/or securities are therefore made replaceable, which means that they are transferred outright.³⁹

2.7 Substitution

As discussed in section 4.4 of chapter II, substitution allows a collateral provider to exchange collateral provided at an earlier moment for another type of collateral of the same value. This means that the financial collateral initially provided is transferred from a collateral taker to a collateral provider, while at the same time the collateral provider replaces this financial collateral with other financial collateral acceptable to the collateral taker. The Dutch *causa* that is most applicable to these transfers is an agreement to exchange assets (*ruil*). As noted in section 2.4.1 (Option 2: sale / exchange agreement) above, the agreement to exchange is regulated in Articles 7:49-50 of the NCC and, if combined with the actual delivery

37 On the provision of collateral by way of a right of pledge in securities lending transactions, see section 2.4.1.c above.

38 See section 4.3 of chapter II.

39 On this issue, see also Graaf 1998/1999, section 3.4.

of assets by parties entitled to dispose of those assets, entails an outright transfer.

In any case, it is evident that transfers under a substitution arrangement are, just like transfers under a margin arrangement, not carried out for recovery purposes only. The financial collateral transferred does, of course, serve a recovery purpose, but in line with the provisions of, for example, the GMRA and the GMSLA, it can also be used by the parties to enter into further trading activities. Under general principles of civil law, these two goals can only be reached by an outright transfer of title.

2.8 Conclusion: an outright transfer of title is the market standard

The conclusion is that an outright transfer of title is the market standard for providing financial collateral in repo and securities lending transactions. This is evident in different standard agreements, such as the GMRA and the GMSLA, which are used to document such transactions. The method of outright transfer is also customarily used by market participants in the Netherlands in the course of repurchase and securities lending transactions. Different Dutch legal constructions are used to shape the title transfer method set out in international standard documentation. In the case of repos, financial collateral is customarily transferred on the basis of an agreement of sale, whereas in securities lending transactions, financial collateral is usually provided on the basis of a loan of fungibles. When determining the *causa* of margin collateral transferred in repo or securities lending transactions, the concept of replaceability is most appropriate. An asset is made replaceable when the transferee of that asset is given an unlimited right of disposal, while also being under the obligation to transfer equivalent assets at a later date. Replaceability entails an outright transfer. The *causa* in the case of substitution arrangements is the agreement to exchange assets.

3. RECHARACTERISATION AS A SECURITY INTEREST?

3.1 Introduction

Based on the discussion in section 2 above, it appears that market participants usually choose the title transfer method of providing financial collateral. The current section investigates why they do so and why they are afraid of a title transfer being recharacterised as a security interest.

In many jurisdictions, a so-called 'recharacterisation risk' is perceived when collateral is transferred outright. Recharacterisation occurs when an outright transfer of title is recharacterised – for example, in the course of legal proceedings – as a security interest, such as a pledge or a fiduciary transfer of title. Recharacterisation can be harmful to secured parties. If under Dutch law, for example, a title of transfer should actually be qualified as a title to establish a security interest, no transfer can take place, whereas a security interest arises only if the formal requirements for establishing a security interest have been met (see section 3.2.4 below). Likewise, in other jurisdictions, such as the United Kingdom, the consequence of characterising a title transfer as a security interest may be that the requirements for the valid establishment of the security interest (e.g., registration of the security interest) should have been complied with. Non-compliance with such requirements can result in a situation in which no collateral at all has been provided.⁴⁰

The perception of a recharacterisation risk arises from the fact that different rights in respect of assets can be granted to a counterparty. One can transfer full title to the counterparty (such as an unlimited transfer of the right of ownership of an asset or an outright transfer of a contractual claim), or a limited proprietary right can be established in respect of an asset (such as a right of pledge). A third option would be to transfer title while, at the same time, limiting the powers of the transferee. This latter option is usually referred to as a 'fiduciary' transfer of title, which, in its legal consequences, is very similar to a right of pledge. Choosing any of these options is dependent on the actual intentions of the parties and on the structure of the legal system in which they operate. If a collateral provider wishes to grant the fullest spectre of rights, he will choose an unconditional transfer of title. If he wishes to provide a right to have recourse only, he should vest a security interest, for example, by vesting a right of pledge or (if allowed under the applicable national law) by transferring title on a fiduciary basis. The consequence of vesting a security interest is that a fiduciary relationship arises between the parties in which their mutual interests should be taken into account. In the case of an outright transfer, a comparable fiduciary relationship does not arise. In this case, the transferee is the one and only party entitled to the assets transferred.

40 See, for example, McCormack 2003.

This section starts with an overview of the different types of security interests that can be established under Dutch and German law (section 3.2). The focus is on the practical inconveniences related to the statutory right of pledge under the old Dutch Civil Code and the German Civil Code, then on to the appearance of a fiduciary transfer of title on the basis of case law in the beginning of the twentieth century, to subsequent refinements in case law that established the contents of the fiduciary relationship and struck a fair balance between the interests of the parties involved, and finally, to the prohibition of fiduciary transfers of title in the Netherlands in 1992 and the simultaneous introduction of a non-possessory right of pledge in relation to physical assets and a right of pledge in respect of claims without a notification requirement.

Section 3.3 compares security interests and title transfers by investigating the different functions they fulfil. In particular, it examines the extent to which a clear distinction between these functions serves as a key to understanding the issue of recharacterisation risk in repurchase and securities lending transactions.

Sections 3.4 – 3.6 investigate three developments that occurred under Dutch law after the introduction of the current Dutch Civil Code in 1992, in which fiduciary transfers of title were prohibited. The focus of section 3.4 is on the Dutch Supreme Court's 1995 *Sogelease* decision, a landmark case concerning the scope of the prohibition of fiduciary transfers of title, with particular attention to the relevance of this decision for repo and securities lending arrangements. The subject matter of section 3.5 is the subsidiary right of pledge that is sometimes envisaged in repurchase and securities lending contracts in the Netherlands because of the perceived recharacterisation risk of a title transfer of financial collateral. Section 3.6 considers special legislation (Article 2a of the STSA) enacted in 1999, which was intended to eliminate the recharacterisation risk in repurchase transactions.

Section 3.7 deals with the approach of the Collateral Directive in respect of recharacterisation risk and the implementation of the directive's provisions in the Netherlands.

3.2 Security interests in the Netherlands and Germany

3.2.1 Introduction

This section gives a more detailed, historical overview of the different ways in which a security interest can be established under Dutch and German law. Section 3.2.2 deals with security interests under the old Dutch Civil Code. Section 3.2.3 makes a comparison with current German law, which resembles old Dutch law in many respects. Finally, section 3.2.4 describes the security interests that can be vested under current Dutch law.

3.2.2 Security interests under the old Dutch Civil Code

a. *The Netherlands Civil Code of 1838*

The Netherlands Civil Code of 1838 envisaged a possessory right of pledge in relation to physical assets and a public right of pledge in respect of claims.⁴¹ Both types of pledge had practical disadvantages. A possessory right of pledge in respect of physical assets could only be vested by giving the pledgee actual possession of the pledged assets. The absence of the possibility of vesting a non-possessory right of pledge turned out to be cumbersome in practice, particularly for enterprises. No security interest was available that could attract credit without risking the loss of assets that might be needed for conducting business (e.g., machinery or raw goods). Moreover, the lack of a non-possessory right of pledge was impractical to providers of credit (particularly banks) because they somehow had to store all assets in respect of which security interests were obtained. Likewise, the public right of pledge in respect of claims had certain drawbacks: a public right of pledge could only be established by giving notice to the debtor of the claim. One of the disadvantages of this requirement was that a party in need of credit often did not want others to know about this need, and thus did not want to notify his debtors when establishing a right of pledge in respect of his claims against those debtors. These drawbacks led to a certain amount of social pressure.

41 In particular, see Articles 1196, 1198 and 1199 of the Netherlands Civil Code of 1838. In 1990 the approach was still essentially the same; see (revised) Articles 1196, 1198, 1198bis and 1199 of the old Dutch Civil Code in Fruin 1990.

b. *The recognition of a fiduciary transfer of title*

It is probably in light of these drawbacks and the resulting social pressure that, in the beginning of the twentieth century, the Dutch Supreme Court recognised a fiduciary transfer of title, i.e. a transfer for recovery purposes (*fiducia cum creditore*). From an economic point of view, such a fiduciary transfer in many ways fulfils the same functions as a right of pledge. The fiduciary transfer of title provided a solution to the main drawbacks of the requirements of possession and notification when establishing a right of pledge under the old Dutch Civil Code.

In the case of a fiduciary transfer of physical assets, the fiduciary normally did not obtain physical custody of the assets transferred. Delivery of the assets to the fiduciary customarily took place by means of a *constitutum possessorium*. This means that the transferor physically kept the assets in his power but declared that he was no longer entitled to them – that he held them for the fiduciary.⁴² If the assets were physically located with a third party, delivery was effected by informing this third party of the fact that 'indirect' or 'constructive' possession was now vested in the transferee (delivery *longa manu*). Only rarely did a fiduciary transfer of title take place in order to establish a possessory security interest. In this instance, a title transfer, albeit limited in its consequences, would have meant an unnecessary over-endowment of the security taker's rights, because the over-endowment related to the title transfer method could easily be prevented by establishing a possessory right of pledge.

A fiduciary transfer of claims also provided a solution for the mandatory notification of the debtor under pledge law. In case of a fiduciary transfer of a claim, no notification of the debtor was required because a transfer of a claim under the old Dutch Civil Code could be realised by the transferor and transferee, without notification of the debtor.

The first decision of the Dutch Supreme Court that recognised a fiduciary transfer of title was the *Bierbrouwerij* decision.⁴³ Shortly afterwards the Supreme Court issued the *Hakkers / Van Tilburg* decision, in which the approach taken in the *Bierbrouwerij* decision was confirmed.⁴⁴ The *Bierbrouwerij* and the *Hakkers / Van Tilburg* decisions were rather straight-

42 Under current Dutch law, the delivery by way of *constitutum possessorium* is regulated in Article 3:115(a) of the NCC. See also Article 3:90(2) of the NCC.

43 Decision of 25 January 1929, *Nederlandsche Jurisprudentie* 1929, pp. 616-621.

44 Decision of 21 June 1929, *Nederlandsche Jurisprudentie* 1929, pp. 1096-1098.

forward decisions that sanctioned the fiduciary transfer of title, but which did not yet determine the exact contents of the fiduciary relationship between the parties. These were further developed and refined both in doctrine and, in particular, by a number of additional decisions of the Supreme Court (see subsection c on the 'Limitations to the rights of the fiduciary' below). The fiduciary transfer of title figured as a security interest until the revision of the Dutch Civil Code which, as far as security interests are concerned, took effect in 1992.⁴⁵

c. *Limitations to the rights of the fiduciary*

In general, under old Dutch law, a fiduciary transfer of title was not primarily considered as a security interest. It was considered first of all as a transfer of title. Nonetheless, the rights of the transferee/fiduciary were limited on a number of accounts in the jurisprudence that appeared after the *Bierbrouwerij* and the *Hakkers / Van Tilburg* decisions. It became necessary to further determine the rights and obligations of all the parties involved in such a transfer, and specifically to establish the exact content of the fiduciary relationship between transferor and fiduciary. Subsequent decisions of the Supreme Court (see the references in footnotes 47, 48, 50 and 51 below) indeed established a balance between the interests of collateral provider and collateral taker. They prevented an over-endowment of rights of the fiduciary, and took the interests of the collateral provider and his creditors into account. The most important limitations to the rights of the fiduciary are outlined below.⁴⁶

1. One limitation to the right of the fiduciary was that, in principle, the assets transferred automatically fell back to the original title-holder upon fulfilment of the secured obligation. The reason for this is that a fiduciary transfer of title was generally considered to be a transfer under a condition subsequent (*ontbindende voorwaarde*). If the condition of payment of the secured debt was fulfilled, the fiduciary lost his interest, and title automatically fell back to the original title-holder. It should, however, be mentioned that the parties could have agreed upon a contractual re-delivery obligation of the fiduciary upon fulfilment of the secured debt.

45 See Asser Series 3-I, nos. 219 and 265; Van Mierlo 1988; Pitlo / Reehuis, Heisterkamp 2001, particularly sections 760 and 806.

46 See Van Mierlo 1988; Snijders 1970, pp. 30-32; Reehuis 1997, pp. 32-34.

In the absence of such an agreement, the principal rule of the condition subsequent would have applied.⁴⁷

2. The fiduciary had only a limited right of disposal; he did not have the right to transfer full title to a third party (i.e. title not subject to the condition subsequent mentioned above), unless his counterparty defaulted in respect of the secured claim.

3. It was generally accepted that the fiduciary should, in the event of a default, have recourse in accordance with the provisions of pledge law. This meant, for example, that the fiduciary was not allowed to appropriate the assets to which his fiduciary right related; rather, he was obliged to sell them and have recourse to the proceeds of the sale. Any remaining surplus value should be paid by the fiduciary to the original title-holder.⁴⁸

4. The title that the fiduciary had acquired was not always enforceable against the rights of the collateral provider's other creditors. Under certain circumstances the rights of certain other, third party creditors could prevail over those of the fiduciary. In cases that came before the Dutch Supreme Court, the rights of those other creditors prevailed where assets that were transferred to the fiduciary by way of a *constitutum possessorium* and that were still under the control of the beneficiary were concerned.⁴⁹ One case related to a claim of a creditor with a privileged position arising out of a sale agreement (*verkopersvoorrecht*), another to certain claims of a creditor with a privileged position based on the General law relating to customs and excise duties.⁵⁰ Yet another decision of the Supreme Court

47 See the Supreme Court's decision of 3 October 1980, *Nederlandse Jurisprudentie* 1981, no 60 (*Ontvanger / Schriks q q*), with an annotation by Kleijn, and further discussed in Van der Grinten 1981. See also as affirming the approach of the *Ontvanger / Schriks* decision, the Supreme Court's decision of 18 February 1994 in *Nederlandse Jurisprudentie* 1994, no 462 (*Nijverdal Ten Cate / Wildervank q q*), with an annotation by Kleijn, and further discussed in Faber / Van Hees 1994 and in Kortmann 1994 III. See also Asser Series 3-I, no 219, Van Mierlo 1988, chapter 2, Snijders 1970, pp 30-31 (section a). The approach of German law is different, see below.

48 See the Supreme Court's decisions of 3 January 1941, *Nederlandsche Jurisprudentie* 1941, no 470 (*Boerenleenbank Hazerswoude-Koudekerk / Los*) and of 30 January 1953, *Nederlandse Jurisprudentie* 1953, no 578 (*Bank van Doyer en Kalff / Bouman q q*), with an annotation by Houwing, and section 3 4 2 of the Supreme Court's decision of 19 May 1995, *Nederlandse Jurisprudentie* 1996, no 119 (*Sogelease*). See also Van Mierlo 1988, section 4 3, Reehuis 1997, p 33.

49 On this topic, see Van Mierlo 1988, section 4 2.

50 See the Supreme Court's decisions of 6 March 1970, *Nederlandse Jurisprudentie* 1970, no 433 (*Van Wessem q q / Traffic*), further discussed in Van der Grinten 1970, and of 7 March 1975, *Nederlandse Jurisprudentie* 1976, no 91 (*Van Gend en Loos*), further

related to a conflict between a reservation of title and a subsequent fiduciary transfer of ownership in respect of the same assets. In this latter case, the prior reservation of title prevailed over the fiduciary transfer.⁵¹

These limitations make up the fiduciary relationship between transferor and fiduciary and are generally in line with the pledge principles outlined in section 1.3 of this chapter. Limiting the rights of the fiduciary protected the interests of the original title-holder and his creditors. In effect, the title that the fiduciary had acquired was a security interest.⁵²

3.2.3 Security interests under the German Civil Code

a. Introduction

This section relates to security interests under the German Civil Code. German law went through a development comparable to that of Dutch law (see section 3.2.2 above). The security interests currently available under German law are, in many respects, comparable to those of old Dutch law.⁵³

b. The German Civil Code of 1900

Like the Dutch legislator in 1838, the German Civil Code of 1900 only envisaged a possessory right of pledge in relation to physical assets and required notification of the debtor for the establishment of a right of pledge in a claim. These limitations also led to practical inconveniences in Germany. An enterprise could not vest a security interest in the assets that it needed in the course of its business, and credit providers were faced with the difficulty of storing those assets in which they had received a

discussed in Van der Grinten 1975. For a case in which the right of a fiduciary prevailed over that of a creditor with a preferential position arising out of a sale agreement (*verkopersvoorrecht*), see the Supreme Court's decision of 18 September 1987, *Rechtspraak van de Week* 1987, no. 166 (Berg & Sons Ltd.).

51 See the Supreme Court's decision of 4 December 1998, *Nederlandse Jurisprudentie* 1999, no. 549 (*Pothorst / Serrée*), with an annotation by Kleijn and with a further analysis by Van Mierlo in *Ars Aequi* 48 (1999) 4, pp. 288-296.

52 Note, however, that there are also differences between the right of pledge and a right of fiduciary ownership. For example, the question of whether a fiduciary ownership right has an accessory character is disputed. Most authors are of the view that it has no accessory character. On this issue, see e.g. Snijders 1970, pp. 30-31 (section a); Faber / Van Hees 1994; Kortmann 1994 III.

53 For an excellent outline of security interests in movables under German law, see Serick 1990. See also Baur / Stürmer 1999, §§ 57 and 58; Jäkel 2001; Strothmann 1995.

security interest. The notification requirement for establishing a right of pledge in a claim was also inconvenient. Sometimes a creditor simply did not want his debtors (and others) to know that he was seeking external credit from, for example, a bank. Another inconvenience was that a pledge on a future claim could not be established under German law because the identity of the creditor who should be notified was not clear – meaning that no notice could be given.⁵⁴ For these reasons, an alternative legal construction was necessary: the fiduciary transfer of title was debated. It was, however, questioned whether a 'secret' security interest, in which no actual possession was provided or no notification was given, was compatible with the legislator's position of allowing a public right of pledge (with the provision of actual possession or notification) only.

c. *The recognition of a fiduciary transfer of title*

As in the Netherlands, the German judiciary sanctioned the concept of a fiduciary transfer of title. The legislator's choice to envisage only a right of pledge in the German Civil Code of 1900 was not seen as an impediment to allowing the fiduciary transfer of title. At present, this construction is fully recognised as customary law (*Gewohnheitsrecht*) by legal scholars and the judiciary. While it has not been explicitly regulated in the German Civil Code, it is structured in accordance with principles contained in the Code.

Under German law, as under old Dutch law, a transferor does not customarily provide the transferee with immediate possession in a fiduciary transfer of physical assets. If the transferor is actually in the possession of the goods transferred, delivery usually takes place by way of a *constitutum possessorium* (see § 930 of the GCC). If the assets are physically located with a third party, delivery is effected by informing this third party that 'indirect' or 'constructive' possession is now vested in the transferee. A fiduciary transfer of physical assets can also be based on the actual provision of possession, but in this case, the traditional possessory pledge is available. This new, non-possessory security interest gave enterprises the possibility of continuing the use of those assets in which they had vested a security interest, and ensured that security takers would not be faced with the burden of storing all sorts of assets from the providers of

54 On the inconveniences connected with the pledge of claims and the notification requirement, see Serick 1990, section 5.II.3-4.

security. As far as the fiduciary transfer of claims is concerned, no notification to the debtor of the claim is required for an effective transfer.⁵⁵

d. *Limitations to the right of fiduciary*

As in old Dutch law, under current German law a fiduciary transfer of title is considered primarily as a transfer of title and not as a security interest. However, under German law, the fiduciary's rights are limited in order to balance the interests of the parties involved. Fiduciary transfers can be structured as a transfer under a condition subsequent, as under Dutch law, but often they are not.⁵⁶ The transferee is normally under an obligation to retransfer title to the transferor once the transferor has fulfilled his obligation towards the transferee.⁵⁷ This, however, does not mean that the transferee has an absolute right. In Serick's view, for example, a fiduciary transfer should be distinguished from an outright transfer. The parties are in a fiduciary relationship. This is particularly evident in the event of the fiduciary's insolvency, in which case the original title-holder can ward off the claims of the fiduciary's creditors, as if no transfer had taken place. The rights of the original title-holder in this case have a 'quasi-real effect'.⁵⁸

Moreover, the fiduciary relationship between the parties sets a number of additional limitations on the powers of the fiduciary. Although the fiduciary as an owner may be *able* to execute certain powers in respect of the assets transferred, the fiduciary relationship does not *allow* him to do so. For example, the fiduciary is not allowed to dispose of the assets transferred as if he had full title. It is only when the transferor does not fulfil the obligation that the assets transferred on a fiduciary basis intend to secure, that the transferee is entitled to transfer full title of these assets to

55 In relation to this historical development, see the Drafters of the GCC, pp 390-439, Serick 1990, particularly Chapter 113, Chapter 5 and Chapter 711

56 Under old Dutch law, in principle, assets that are transferred on a fiduciary basis automatically fall back to the original title-holder upon fulfilment of the secured claim because they are deemed to be transferred under a condition subsequent, no act of (re-)delivery is required (see section 3.2.2 above)

57 See Baur / Stürmer 1999, § 57(45), Snijders 1970, p 30

58 Under certain circumstances, German insolvency and execution law (*Insolvenzrecht* and *Vollstreckungsrecht*) recognises that claims of a non-proprietary nature, such as the claim for re-delivery against a fiduciary, can also be successfully invoked should the fiduciary be subject to insolvency or execution proceedings. This is because, even if, from a strictly legal point of view, the claim against the fiduciary is of a non-proprietary nature, from an economic point of view, the assets transferred for security purposes are those of the original title-holder

a third party. The original owner and the fiduciary may agree that, in the event of default, the fiduciary has the right to enforce his rights in accordance with the terms of the contract between the parties, but in the absence thereof, the enforcement procedures of pledge law are applied by way of analogy.⁵⁹ In addition, in the event of default, the transferee is not allowed to appropriate the assets but, like a pledgee, has only the right of separate and privileged satisfaction out of the proceeds of a sale, with any surplus value falling to the original owner and his creditors.⁶⁰

The limitations of the rights of the fiduciary follow from the security function of the fiduciary transfer of title. In part, these limitations (particularly in the case of insolvency) have quasi-real effects on third parties. The result of the limitations is that the fiduciary essentially has only the rights that a pledgee would have if a right of pledge had been established. If the structure is considered in its entirety, the conclusion is that, in effect, the fiduciary has not obtained full title, only a security interest.⁶¹

e. Security interests under current German law

The security interests that can be established under current German law are comparable to those available under old Dutch law. Statutory law provides for a possessory right of pledge in respect of physical assets and for a right of pledge in respect of claims that can only be established if the debtor is notified. In addition, both the judiciary and legal literature recognise fiduciary transfers of title. This makes it possible to establish a non-possessory security interest in respect of physical assets, and a security interest in relation to claims, for the establishment of which notification of the debtor is not compulsory.

59 See Baur / Stumer 1999, § 57(41-42). In this respect, German law is more liberal than Dutch law, which sticks more closely to the provisions of the NCC relating to the enforcement of a right of pledge. See section 3.2.2 above.

60 The issue of appropriation is somewhat controversial. See Baur / Stumer 1999, § 57(16).

61 In regard to these different issues, see Serick 1990, Baur / Stumer 1999, §§ 57 and 58. On the quasi-real effects of fiduciary transfers in particular, see Serick 1990, section 1 IV (with further references).

3.2.4 The abolition of fiduciary transfers of title in the new Dutch Civil Code

a. The view of Meijers

Meijers, who was asked to design a new Dutch Civil Code in 1947, was no protagonist of fiduciary structures, whether a *fiducia cum creditore* (which relates to a transfer of property for the purposes of security; *overdracht tot zekerheid*) or a *fiducia cum amico* (a transfer of property to an administrator, whose task is the management of that property in the original title-holder's interest; *overdracht ten titel van beheer*). In Meijers's view, the outright transfer method was not appropriate for the establishment of either a security interest or an administration relationship. He believed that a security interest should be established by way of a pledge and that if one party desired to provide assets to another party for administration, he should do so by establishing an administration relationship (*bewind*). An outright transfer of, for example, the right of ownership or of claims should not be used to confer only a limited right upon another party (whether for the purposes of security or administration).^{62 63}

Meijers passed away in 1954, at which time he had completed a considerable part of the draft of the new Civil Code, including the parts on transfer of title and the law of pledge and of hypothec (mortgage). In his draft, he proposed a prohibition of fiduciary transfers of title and laid the basis for the introduction of a right of pledge without notification requirements (such as the provision of actual possession of physical assets or notification of the debtor of a claim).⁶⁴

b. The view of Snijders

After Meijers' death, there was still a lot of work to do before the new Civil Code could be enacted. One of Meijers' successors, Government Commissioner Snijders, was, like Meijers, in favour of introducing a right of pledge without publication requirements in the new Civil Code. He pointed out that there were a lot of uncertainties connected to the fiduciary transfer of title as developed by the judiciary and in legal literature.

62 See Meijers' Explanatory Notes, Article 3.4.2.2; Meijers 1948, pp. 89-90.

63 The *fiducia cum amico* will not be further considered here because it is the prohibition of the *fiducia cum creditore* that has led to doubts in the collateral market, and in particular the question of under what circumstances an outright transfer of title runs the risk of being recharacterised as a security interest.

64 See Meijers' Explanatory Notes, Title 3.4 and Title 3.9.

A codified right of pledge could, in his view, eliminate these doubts to a large extent. In addition, the legislator could, when codifying the right of pledge in the new Dutch Civil Code, balance the interests of all the parties involved.⁶⁵

c. Security interests under current Dutch law

In 1992, the Dutch legislator did indeed abolish fiduciary transfers of title in Article 3:84(3) of the NCC, as follows:

A juridical act intended to transfer property for purposes of security or which does not have the purpose of vesting title in the acquirer, after transfer, does not constitute valid title for transfer of that property⁶⁶

A valid title is one of the three mandatory requirements for a valid transfer under Dutch law, in addition to the transferor's right to dispose of the assets concerned and a formal act of delivery.⁶⁷ Therefore, if the title of transfer is invalid under Article 3:84(3) of the NCC, no transfer takes place at all.

Simultaneous with the introduction of Article 3:84(3) of the NCC, the legislator introduced a non-possessory right of pledge in respect of physical assets in Article 3:237 of the NCC. In addition, Article 3:239 of the NCC envisages a right of pledge without mandatory notification to the debtor, so as to replace the fiduciary assignment of claims. Therefore, if parties currently wish to establish a security interest under Dutch law, they must vest a right of pledge.⁶⁸

65 See Snijders 1970

66 Translation Netherlands Business Legislation Original Dutch text 'Een rechtshandeling die ten doel heeft een goed over te dragen tot zekerheid of die de strekking mist het goed na de overdracht in het vermogen van de verkrijger te doen vallen, is geen geldige titel van overdracht van dat goed'

67 See Article 3:84(1) of the NCC

68 See Reehuis 1997, section 2, for a historical overview of the system of security interests in the Netherlands. See also the Parliamentary History of the NCC, *Boek 3, Vermogensrecht in het algemeen*, Article 3:422, pp. 316-319, Asser Series 3-I, nos. 219, 239, 241-242 and 265, Pitlo / Reehuis, Heisterkamp 2001, sections 760 and 806. See Florijn 1994 for a general overview of the history of the current Dutch Civil Code.

3.3 Recharacterisation risk: a function-based approach

3.3.1 Introduction

The parties to repurchase and securities lending agreements often fear the re-characterisation of a title transfer as a security interest. This section investigates whether the risk of recharacterisation can be assessed by taking a 'function-based approach', i.e. an approach in which this risk is determined on the basis of the functions that financial collateral should fulfil according to the parties to a financial collateral arrangement.

Section 3.3.2 relates to the functions of title transfers and security interests in general (without specific reference to financial collateral arrangements). This section compares the functions of a title transfer to those of a security interest. Section 3.3.3 applies this analysis to financial collateral arrangements. It examines whether analysing the functions of security interests and title transfers can be helpful in determining whether any recharacterisation risk exists in such arrangements. To this end, the functions of financial collateral arrangements are investigated to determine whether they point in the direction of a title transfer or a security interest.

3.3.2 *The functions of title transfers as opposed to security interests*

A title transfer and a security interest serve essentially different functions. A title transfer entails a transfer of all right, title and interest without limitations. While the establishment of a security interest can also be viewed as a transfer of rights, this transfer only relates to those rights that serve the goal of creating an object for recourse. Title is, in this case, still vested in the collateral provider, even when this title has been encumbered with a security interest. In other words, a security interest is a limited right: the collateral provider only provides the collateral taker with those rights that serve the goal of recovery. If more rights were to be transferred, it would lead to an over-endowment of rights to the benefit of the collateral taker. In order to guarantee a balance between the interests of the collateral provider and collateral taker, security interests have certain characteristic features that have already been outlined in section 1.3 of this chapter. These features reflect the fact that the collateral provider and the collateral taker are in a fiduciary relationship. This section examines in more detail the features of security interests that are directly connected with its recovery function: the prescribed method of sale, the prohibition of appropriation and the collateral provider's right to

a possible surplus value. These limitations on the collateral taker's rights are inherent to security interests and do not exist in the case of an outright transfer of title, which entails an unlimited transfer of rights.

a. A prescribed method of sale

Under normal circumstances, a pledgee is not allowed to dispose of the assets in which he has a security interest. Only upon an event of default, if the pledgor does not or cannot properly fulfil the secured obligation, may a pledgee dispose of pledged assets. In the case of default, the sale of these assets by the pledgor is subject to strict requirements, which are intended to protect the interests of the collateral provider and his creditors against fraudulent enforcement by a collateral taker and to maximise proceeds.

Under Dutch law, the first way a pledgee can enforce his rights is by conducting a public sale of the encumbered assets. This ensures that assets are not sold at too low a value. The requirement for a public sale follows from Article 3:250(1) of the NCC, which states:

The sale shall take place in public according to local customs and upon the usual conditions.⁶⁹

In the case of property that is traded in a market or on an exchange, a sale with a public character in the sense of Article 3:250(1) of the NCC does not necessarily have to take place. The sale may also be carried out in that market or on that exchange by an appropriate broker or a qualified intermediary. In this case, there are two factors that guarantee an objective price: the fact that the prices in a market or on an exchange are usually transparent, and the involvement of an impartial broker or intermediary. See Article 3:250(2) of the NCC, which states:

The sale of pledged property which can be traded in a market or on an exchange may take place in the market through an appropriate broker or, on an exchange, through a qualified intermediary, according to the rules and usages applicable to an ordinary sale in such market or on such exchange.⁷⁰

69 Translation: Netherlands Business Legislation. Original Dutch text: 'De verkoop geschiedt in het openbaar naar de plaatselijke gewoonten en op de gebruikelijke voorwaarden.'

70 Translation: Netherlands Business Legislation. Original Dutch text: 'Bestaat het pand uit goederen die op een markt of beurs verhandelbaar zijn, dan kan de verkoop geschieden op een markt door tussenkomst van een tussenpersoon in het vak

Article 3:251 of the NCC provides for two other ways to enforce a right of pledge. First, on the basis of Article 3:251(1) of the NCC, the pledgor or the pledgee can – unless otherwise stipulated – ask the interim provisions judge (*voorzieningenrechter*) to intervene, in which case the interim provisions judge determines how the sale should be conducted, or for what price the pledgee may buy the property. Here, the intervention of the interim provisions judge guarantees fair enforcement. Article 3:251(1) of the NCC states:

Unless otherwise stipulated, the interim provisions judge of the district court may determine, at the request of the pledgee or the pledgor, that the pledged property will be sold in a manner which deviates from the preceding article; at the request of the pledgee, the interim provisions judge of the district court may also determine that the pledged property will remain with the pledgee as buyer for an amount to be determined by him⁷¹

A second alternative to the public sale of Article 3:250 of the NCC is set out in Article 3:251(2). This provision makes it possible, if no provision to the contrary has been agreed upon, for the pledgor and the pledgee to conclude an agreement between themselves on an alternative manner of sale. This agreement, however, can only be concluded after the moment of default to ensure that the pledgor (or the insolvency administrator who represents the interests of the insolvent estate) is no longer in a dependent position. Again, this guarantees that pledged assets are not sold at too low a price. Article 3:251(2) of the NCC states:

A pledgee who has become entitled to proceeds to a sale may agree with the pledgor to a manner of sale which deviates from the preceding article []⁷²

The requirements under German pledge law that guarantee maximum proceeds are comparable to those set out under Dutch law. As a matter of principle, § 1235(1) of the GCC requires a public sale:

of ter beurze door die van een bevoegde tussenpersoon overeenkomstig de regels en gebruiken die aldaar voor een gewone verkoop gelden '

71 Translation Netherlands Business Legislation. Original Dutch text 'Tenzij anders is bedongen, kan de voorzieningenrechter van de rechtbank op verzoek van de pandhouder of de pandgever bepalen dat het pand zal worden verkocht op een van het vorige artikel afwijkende wijze, of op verzoek van de pandhouder bepalen dat het pand voor een door de voorzieningenrechter van de rechtbank vast te stellen bedrag aan de pandhouder als koper zal verblijven.'

72 Translation Netherlands Business Legislation. Original Dutch text 'Nadat de pandhouder bevoegd is geworden tot verkoop over te gaan, kunnen pandhouder en pandgever een van het vorige artikel afwijkende wijze van verkoop overeenkomen []'

The sale of the pledge shall be effected by public auctions.⁷³

For pledged assets that are traded on an exchange or in a market, § 1235(2) of the GCC refers to § 1221 of the GCC, which allows for the sale of those assets on the stock exchange or market by an independent intermediary:

If the pledge has a stock exchange or a market price, the pledgee may effect the sale privately at the current price through a broker officially authorised to carry out such sales or through an authorised public auctioneer.⁷⁴

Like Dutch law, German law also allows an agreement between the pledgor and the pledgee in relation to the manner of sale. Insofar as such an agreement deviates from the public sale requirement of § 1235, it can, however, only be concluded after the moment of default. After that moment, the pledgor is no longer deemed to be in a dependent position and can represent his interests (and those of his creditors) properly. See § 1245 of the GCC:

The owner and the pledgee may agree on selling the pledge in a manner which deviates from the provisions of §§ 1234 to 1240. [...] Compliance with the provisions of § 1235 [...] may not be waived before the right of sale arises.⁷⁵

Moreover, an alternative manner of sale can be claimed by one of the parties on the basis of reasonableness. If the counterparty does not agree to the proposed manner of sale, the court decides. See § 1246 of the GCC, which states:

1. If a manner of sale deviating from the provisions of §§ 1235 to 1240 corresponds equitably with the interests of the parties concerned, each of them may demand that the sale be made in such manner.

2. If there is a failure to agree, the court decides.⁷⁶

73 Translation: Goren 1994. Original German text: 'Der Verkauf des Pfandes ist im Wege öffentlicher Versteigerung zu bewirken.'

74 Translation: Goren 1994. Original German text: 'Hat das Pfand einen Börsen- oder Marktpreis, so kann der Pfandgläubiger den Verkauf aus freier Hand durch einen zu solchen Verkäufen öffentlich ermächtigten Handelsmäkler oder durch eine zur öffentlichen Versteigerung befugte Person zum laufenden Preis bewirken.'

75 Translation: Goren 1994. Original German text: 'Der Eigentümer und der Pfandgläubiger können eine von den Vorschriften der §§ 1234 bis 1240 abweichende Art des Pfandverkaufs vereinbaren. [...] Auf die Beobachtung der Vorschriften des § 1235 [...] kann nicht vor dem Eintritt der Verkaufsberechtigung verzichtet werden.'

76 Translation: Goren 1994. Original German text: '1. Entspricht eine von den Vorschriften der §§ 1235 bis 1240 abweichende Art des Pfandverkaufs nach billigem Ermessen den Interessen der Beteiligten, so kann jeder von ihnen verlangen, dass

In the case of a fiduciary transfer of title, it is sometimes argued that the manner of enforcement is not subject to formal requirements, as is true for a right of pledge. In particular, under German law, the parties have the freedom to determine the manner in which enforcement takes place. In the absence of an agreement, however, the above-mentioned provisions and principles of pledge law apply. By contrast, the common opinion under old Dutch law was that the fiduciary should act as much as possible as a pledgee when enforcing his security interests. Like a pledgee, a fiduciary has fiduciary obligations towards the provider of security. By applying the enforcement provisions of pledge law to fiduciary transfers of title, maximum proceeds were guaranteed and the original title-holder and his creditors were protected against unfairness on the side of the fiduciary.⁷⁷

b. The prohibition of appropriation

A shared characteristic of a right of pledge and (under old Dutch and current German law) a fiduciary transfer of title is the prohibition of appropriation, which is closely linked to the requirements relating to a prescribed manner of sale. This prohibition means that the security taker is not entitled to appropriate the pledged assets upon default. Such appropriation is prohibited because it is feared that the valuation by the security taker will not be transparent, as in, for example, a public sale, and will not result in maximum proceeds. For the right of pledge, the prohibition of appropriation has been codified in Article 3:235 of the NCC and § 1229 of the GCC.⁷⁸

Article 3:235 of the NCC states:

Any stipulation whereby the pledgee or the hypothecary creditor (*mortgagee*) is given the power to appropriate the secured property is null.⁷⁹

§ 1229 of the GCC states:

der Verkauf in dieser Art erfolgt. 2. Kommt eine Einigung nicht zustande, so entscheidet das Gericht.'

77 See the jurisprudence and literature mentioned in sections 3.2.2 and 3.2.3 above.

78 For a comparable approach in relation to fiduciary transfers of title, see sections 3.2.2 and 3.2.3 above.

79 Translation: Netherlands Business Legislation. Original Dutch text: 'Elk beding waarbij de pand- of hypotheekhouder de bevoegdheid wordt gegeven zich het verbonden goed toe te eigenen, is nietig.'

An agreement made before the existence of the right to sell, by which the ownership of the thing falls to the pledgee or is transferred to him, in case he does not, or does not in due time, receive satisfaction, is void.⁸⁰

c. *Right to surplus value*

Another characteristic feature of both the right of pledge and (under old Dutch and current German law) a fiduciary transfer of title is that any possible surplus value upon enforcement of the security interest and fulfilment of the secured obligation must be paid by the security taker to the security provider. For the right of pledge, this principle has been laid down in Article 253 of the NCC and in § 1247 of the GCC.⁸¹

Article 253 of the NCC states:

After paying the costs of the execution, the pledgee shall deduct from the net proceeds the amount owed to him and for which he has a right of pledge. The balance shall be paid to the pledgor [...]⁸²

§ 1247 of the GCC states:

Insofar as the proceeds from the pledge belong to the pledgee for his satisfaction, the claim is deemed as settled by the owner. In other respects the proceeds take the place of the pledge.⁸³

d. *Balance of power between the parties*

The core characteristics of security interests discussed above reflect the limited goal of a security interest. It serves a recovery function, and the collateral taker should not be given more rights than necessary. The core characteristics reflect the reality that a collateral provider and a collateral

80 Translation: Goren 1994. Original German text: 'Eine vor dem Eintritt der Verkaufsberechtigung getroffene Vereinbarung, nach welcher dem Pfandgläubiger, falls er nicht oder nicht rechtzeitig befriedigt wird, das Eigentum an der Sache zufallen oder übertragen werden soll, ist nichtig.'

81 For a comparable approach in relation to fiduciary transfers of title, see sections 3.2.2 and 3.2.3 above.

82 Translation: Netherlands Business Legislation. Original Dutch text: 'De pandhouder houdt, na voldoening van de kosten van executie, van de netto-opbrengst af het aan hem verschuldigde bedrag waarvoor hij pandrecht heeft. Het overschot wordt aan de pandgever uitgekeerd [...]'.⁸³

83 Translation: Goren 1994. Original German text: 'Soweit der Erlös aus dem Pfande dem Pfandgläubiger zu seiner Befriedigung gebührt, gilt die Forderung als von dem Eigentümer berichtigt. Im Übrigen tritt der Erlös an die Stelle des Pfandes.'

taker are in a fiduciary relationship and that a balance must be reached between their respective interests and those of their creditors. Because both the core characteristics discussed above and the goal of reaching a fair balance between the interests of the parties involved in a security interest are deemed to be fundamental, the core characteristics are issues of mandatory law.

Basically, the core characteristics of security interests and the methods used to balance the interests of the parties are applications of the general principle that parties should behave in a fair and reasonable manner towards each other. The application of these characteristics as a guarantee for reasonable behaviour is particularly important when the parties to an agreement are not in an equally powerful position. This is the case, for example, when a financial institution provides credit to an individual person or to a small or medium-sized enterprise.

In the case of an outright transfer of title, a comparable fiduciary relationship between the transferor and the transferee does not arise. In this case, the transferor intends to transfer all right, title and interest to the transferee. This means that, in this case, the application of the characteristics of security interests outlined above is not mandatory.

3.3.3 *The functions of financial collateral*

a. Introduction

This section reviews the functions of financial collateral and examines whether these functions lean in the direction of a security interest or in the direction of a title transfer. It has already been argued in section 2.4 of chapter II that financial collateral provided in the course of repos, securities lending transactions or derivatives usually serves at least two functions: it is used for purposes of recovery ('recovery function') and for engaging in further activities ('tradeability function'). This section examines whether this dual function requirement is more compatible with an outright transfer of title or with vesting a security interest.⁸⁴

⁸⁴ On the two functions of collateral, see De Haas / Keijser 2001, pp. 6-7 and Keijser / De Haas 2001, p. 11. See also Wood 1995 II, pp. 3-24, for a general analysis of circumstances that are relevant in establishing either a security interest or a title transfer.

b. *Recovery function*

In many respects, financial collateral serves the same functions as security interests (see section 3.3.2). A collateral flow has a recovery function. In repos, for example, collateral provided at the outset of a transaction is a safeguard against a defaulting seller; in securities lending, collateral in the form of cash and/or securities covers the risk in relation to the borrower, whereas margin securities, provided in the course of repo or securities lending transactions or under the ISDA Margin Provisions, secure a net exposure arising during a transaction. In other words, financial collateral is intended to secure a net exposure in relation to the counterparty.

The close-out netting mechanisms that are applied in the event of default or termination illustrate this recovery function. The main internationally used standard agreements for repos, securities lending transactions and derivatives (i.e. the Global Master Repurchase Agreement, the Global Master Securities Lending Agreement and the 2002 ISDA Master Agreements) all contain detailed provisions on the process of close-out netting. Generally speaking, this process amounts to the following: after the occurrence of an event of default (e.g., insolvency) or termination (e.g., a merger resulting in diminished creditworthiness), all or a limited number of the parties' transactions are terminated prematurely (either after a notice has been served or automatically). The value of the obligations of the parties is then calculated in accordance with the different procedures set out in the standard documentation, which generally aim at a fair valuation in accordance with market prices (for example, by requiring different price quotes in established markets). The obligations are subsequently expressed in a single currency, and netted. The result is always a single net amount payable by one of the parties.⁸⁵

To a large extent, this procedure is compatible with the core principles of pledge law outlined in section 3.3.2 above, which aim at an economically fair valuation achieved through a prescribed sale and the prohibition of appropriation. In addition, the obligation to pay the single net amount is comparable to the collateral taker's obligation under the pledge principles to pay any surplus value to the collateral provider upon fulfilment of the secured obligation.

⁸⁵ See also sections 4.7 and 8.7 of chapter II and section 3 of chapter V.

A situation in which the economic risk lies with the transferor of financial collateral also fails to support the view that an outright transfer has taken place. The transferor has to account for price fluctuations in respect of collateral transferred in line with the margin maintenance methods discussed in section 4.3 of chapter II. Moreover, the transferee is usually obliged to pay to the transferor amounts equivalent to income payments.⁸⁶ These circumstances could lead to the interpretation that the parties have not intended an unlimited transfer of title, but rather the establishment of a security interest.⁸⁷

c. Tradeability function

As a rule, however, in addition to its recovery function, financial collateral also serves a tradeability function, which means that the collateral can be (and usually is) used to engage in further trading activities. It is for this reason that the transferee of the collateral is under the obligation to transfer equivalent (but not identical) collateral at the end of a transaction. It is essentially this function of tradeability that distinguishes a financial collateral arrangement from traditional security interests. Traditional security interests under Dutch or German law have only a recovery function. The secured party cannot dispose of the secured assets (e.g., to cover a short position or to make money on the markets in any other way) if no default has taken place. The feature of tradeability in addition to recovery is therefore not compatible with a security interest and necessitates an outright transfer of collateral.

d. Extra illustration: the approach under English and American law

Under English and American law, the functions that financial collateral fulfil arguably play a crucial role in determining whether a title transfer is valid or whether it should be recharacterised as a security interest. This section serves as an extra illustration to the argument above: that a title transfer is enforceable if the collateral transferred serves both a recovery and a tradeability function.

⁸⁶ See section 4.5 of chapter II

⁸⁷ The approach of the GMRA and the GMSLA in respect of voting rights in equity transactions does not clearly show which party carries the economic risk. The approaches of the GMRA and the GMSLA differ. Under the GMRA, the collateral provider is, as a rule, entitled to give voting instructions, whereas under the GMSLA, the collateral taker can vote at his own discretion. For further information, see section 3.4.3 b ('Economic risks and benefits') below

Under English law, title transfers of financial collateral are generally considered to be safe. However, provisions in a master agreement or an annex thereto, which reflect the desire of the parties to transfer collateral for recovery purposes only, raise recharacterisation concerns. The limited tradeability of collateral securities may be an indicator that the title transfer structure does not reflect the substance of the parties' intents and that collateral should actually have been provided by establishing a security interest.⁸⁸

The same is true for American law. Schroeder concludes her treatise on repurchase agreements as follows:

I suggest that a repo is a genuine sale and not a security interest if the repo seller loses all of its property interest in the security when it is sold to the repo buyer. This should be evidenced not by self-serving subjective statements of the repo parties, but by the objective evidence of the contractual terms. Specifically, if the repo buyer has the right to sell the repo security and merely sell a substitute security back to the repo seller, the repo should be recognised as a true sale.⁸⁹

As with English law, the 'objective' intent of the parties is decisive under American law. It is not the subjective statements of the parties that are normative, but rather the economic intent of the parties, as this can be objectively established on the basis of the terms of their agreement, for instance. If the collateral taker has both a right to recourse and an unlimited right of disposal, an outright transfer will not be recharacterised as a security interest.⁹⁰

3.3.4 Conclusion

It is submitted that an approach in which the different functions of financial collateral are taken into account, provides a key to understanding the issue of recharacterisation risk. The actual intentions of the parties are decisive when determining whether recharacterisation should take place. In particular, the role the collateral is intended to fulfil should be established: does it serve a recovery function only, or a tradeability

88 See Benjamin 1997 II, pp. 514-515, and the case law there mentioned; Benjamin 2000, pp. 132-134; and the case *Re Curtain Dream plc* published in *Butterworths Company Law Cases*, 1990, pp. 925-939. See also section 3 of chapter IV.

89 See Schroeder 1996, pp. 1049-1050.

90 See Schroeder 1996. Refer also to UCC (2004 edition), Article 8, Prefatory Note III C, sections 10 and 11, pp. 806-808; Kettering 1999 I, pp. 1135-1136; Kettering 1999 II, pp. 205-206; and Scott Pryor 2001, A.2 ('When Less is More Part 2 – Repos'). See also section 2 of chapter IV.

function as well? If the intention of the parties has been to provide assets for recovery purposes only, a security interest should have been established. In this case, the collateral taker and the collateral provider are in a fiduciary relationship, which means, among other things, that the collateral taker is not allowed to dispose of the collateral under normal circumstances. In this event, the tradeability function is therefore absent. The fiduciary relationship arising in the case of a security interest is not compatible with the secured party's general right of disposal. But if both recovery and tradeability functions are envisaged, financial collateral should be provided on the basis of an outright transfer of title.

3.4 The *Sogelease* decision

In section 3.2, a historical overview of the different security interests available under Dutch and German law was provided. In addition, section 3.3 analysed the functions of security interests and compared them to the functions of title transfers. It is now time to pay further attention to the legal situation in the Netherlands after the introduction of the current Dutch Civil Code in 1992, which abolished fiduciary transfers. This in turn requires the exact scope of this prohibition to be determined. A landmark case in this respect is the *Sogelease* decision of the Dutch Supreme Court,⁹¹ which is the topic of this section. Section 3.4.1 below outlines the Supreme Court's decision. Section 3.4.2 discusses the merits and the deficiencies of the *Sogelease* decision, and section 3.4.3 examines the relevance of this decision for transfers of financial collateral under repurchase and securities lending agreements. In addition, the focus in section 3.4.4 is on the recent *BTL Lease* decision of the Dutch Supreme Court.

This section also discusses whether applying the function-based approach set out in section 3.3 above, leads to fair results.

3.4.1 The contents of the *Sogelease* decision

The *Sogelease* decision concerns a sale and financial leaseback transaction. In this case, company A bought printing presses from company B. In order to finance the presses, company A sold them to *Sogelease* and *Sogelease* leased them back to company A. The parties agreed to a so-called 'financial lease', in which the lessor wished to have legal ownership as a means of security, whereas all economic risks were carried by the lessee.

91 Decision of 19 May 1995. See *Nederlandse Jurisprudentie* 1996, no. 119.

This lease was structured on the basis of a reservation of title. Upon the normal expiry of the lease agreement, company A had the right to buy the presses for a symbolic price. It was agreed that company A would carry all economic risks and would activate the presses on its balance sheet. Upon default, Sogelease had stipulated the right to dissolve the lease agreement and sell the presses to a third party.⁹²

The Supreme Court ruled that the sale and financial leaseback construction was valid. The construction consists of two parts. According to the Supreme Court, the first part (i.e. the sale by company A to Sogelease) was an outright transfer of ownership that was not invalid under Article 3:84(3) NCC. On the basis of this right of full ownership, Sogelease was entitled to lease back the printing presses to company A (the second part) on the basis of reserving its right of ownership until all the lease instalments had been paid.

In order to determine whether a prohibited fiduciary transfer of title has taken place, the following circumstances should be considered in line with the *Sogelease* decision: (1) the rights and obligations upon default, including those relating to a prescribed sale, appropriation and surplus value; (2) the party carrying the economic risk in respect of the assets transferred; and (3) the purpose of the transaction according to the real intentions of the parties. These three issues will now be examined in further detail.

a. Rights and obligations upon default

The Supreme Court considered that 'an agreement which in the case of an event of default limits the rights of the party to whom the property is transferred to the right to realise the transferred property in order to have recourse to the proceeds thereof, while this party is also under the obligation to pass on any surplus value to the counterparty, does not constitute a valid legal ground pursuant to Article 3:84(3) of the NCC: in this case the parties should establish a (non-public) right of pledge or a right of hypothec (mortgage).'⁹³ Essentially, the Supreme Court refers to

92 See Van Hees 1997 on leasing

93 Section 3 4 3, second paragraph, of the *Sogelease* decision. Translation. TK. Original Dutch text 'Dienovereenkomstig levert een overeenkomst die de bevoegdheden van degene aan wie het goed wordt overgedragen, in geval van wanprestatie van zijn wederpartij beperkt tot het recht het hem overgedragen goed te gelde te maken ten einde zich uit de opbrengst daarvan te bevredigen onder gehoudenheid een

the core characteristics of security interests, outlined in section 1.3 of this chapter, particularly to the prescribed sale, the prohibition of appropriation and the right of the security provider to any surplus value. In order to establish whether the prohibition of Article 3:84(3) of the NCC to transfer title on a fiduciary basis has been violated, the rights and duties upon default should be assessed. Is the secured party (in this case the lessor) free to do with the object whatever he pleases (e.g., to appropriate it or sell it to a third party), or is he obliged to sell the asset in question upon default? If the secured party is obliged to sell, it is important to determine whether this sale has the character of a public sale and is carried out for purposes of recourse. In addition, it must be determined whether the secured party is under the obligation to transfer any surplus value to his counterparty after the realisation has taken place.

The outright transfer method can, as the *Sogelease* decision shows, be applied to provide security. A transfer is not in violation of Article 3:84(3) of the NCC if the parties have agreed that, in the event of default on the part of the counterparty, the secured party only needs to dissolve the agreement in order to again have the unlimited right to dispose of the property freely (which basically boils down to an appropriation of the property) and that the secured party is not under any obligation to pay any surplus value to the counterparty upon default. If, however, the secured party must, like a pledgee, conduct a public sale in order to guarantee maximum proceeds and is obliged to transfer any surplus value to the provider of security, these are very strong indicators that the parties should actually have established a right of pledge.

b. Economic risk

Is economic risk a factor that indicates whether an outright transfer or a fiduciary transfer has taken place? In the *Sogelease* case, it had been agreed that the provider of security (the lessee) would carry the economic risk and would bear the maintenance costs in relation to the sold and leased printing presses. The assets transferred were even registered on the lessee's balance sheet. Because economic risk is usually vested in the owner of assets, it could be concluded that *Sogelease* (the lessor) had not become the owner of the printing presses but that it had been the intention of the

eventueel overschot aan zijn wederpartij ten goede te doen komen, ingevolge art. 3:84 lid 3 niet een geldige titel voor overdracht op: partijen dienen dan gebruik te maken van (stil) pandrecht, onderscheidenlijk van hypotheek.'

parties to give Sogelease a limited proprietary right only. The Supreme Court's decision, however, makes it clear that the question of whether an outright or fiduciary transfer of title has taken place is not determined by which party carries the economic risk arising in connection with the property transferred. The Supreme Court ruled: 'Also a contractual provision under which the maintenance costs and risk remain for the account of the transferor does not mean that no "true transfer" as mentioned above has taken place.'⁹⁴ Even though the economic risks were not carried by the transferee of the printing presses (the lessor), the Supreme Court considered the lessor to be the full owner thereof. The factor of economic liability, therefore, does not determine whether the parties should transfer ownership outright or establish a security interest.

The Supreme Court's decision is in line with the explanation of Article 3:84(3) of the NCC given by the Minister of Justice, making it clear that a transfer of title is not necessarily of a fiduciary nature if it is accompanied by a contractual arrangement that states that (1) the fruits and other advantages of the transferred assets are for the benefit of the original title-holder and (2) the original title-holder carries the economic risk arising in respect of these assets.⁹⁵ Such contractual provisions have no direct effect on the level of property law, even though they may give an indication of the actual intentions of the parties. If economic risk is vested in the transferee, this is a strong indicator that an outright transfer has taken place, whereas if the transferor remains economically liable, this can be an indication that he is still the owner and that it was intended that the transferee be given a security interest only.

c. Motivations other than security

The Supreme Court explicitly stated that the fact that a transaction has also been entered into for security purposes (in addition to other purposes) does not necessarily mean that the transaction is in violation of Article 3:84(3) of the NCC.⁹⁶ It should, therefore, be determined what the exact intentions of the parties to a transaction are. If they have transferred

94 Section 3.4.3, fourth paragraph, of the *Sogelease* decision. Translation: TK. Original Dutch text: 'Evenmin staat een beding krachtens hetwelk onderhoud en risico voor rekening van de overdrager blijven, eraan in de weg aan te nemen dat de overeenkomst strekt tot een "werkelijke overdracht" in voormelde zin.'

95 See the Parliamentary History of the NCC, *Boek 3: Vermogensrecht in het algemeen*, Article 3.4.2.2, pp. 318-319 (M.v.A. II).

96 See, in particular, section 3.4.3, fourth and fifth paragraphs, of the *Sogelease* decision.

title with the sole intention of securing an outstanding debt, the transfer is invalid under Article 3:84(3) of the NCC. But if the transaction is also entered into for other reasons, the title transfer method can, under some circumstances, be used. The *Sogelease* case shows that the Supreme Court is inclined to accept the presence of other such motivations to justify the use of the title transfer method.

Essentially, a sale and financial leaseback is a financing construction in which objects are transferred as security for a loan that is paid back in the form of lease instalments. According to the Supreme Court, such constructions are not in violation of Article 3:84(3) of the NCC. The circumstance in the *Sogelease* case that distinguished the sale and financial leaseback construction from a traditional security interest in the view of the Supreme Court was, in particular, a contractual agreement that allowed the security taker to dissolve the sale and financial leaseback agreement and to freely dispose of the assets involved.

d. Conclusion

It follows from the *Sogelease* decision that title cannot be transferred under Article 3:84(3) of the NCC if the rights of the secured party are limited to seizing the property, selling it and having recourse to the proceeds thereof, while a duty exists to pay any surplus value to the provider of security. Under such conditions, the secured party is essentially in the same position as a pledgee. In this case, a right of pledge should have been established. The Supreme Court has, however, given Article 3:84(3) of the NCC very limited scope. In line with the Court's decision, a transfer is possible and not in violation of the prohibition of fiduciary transfers of title, as soon as the collateral taker is contractually granted the right to appropriate assets upon default and sell them to a third party.

3.4.2 The merits and deficiencies of the Sogelease decision

In general, the *Sogelease* decision was well received because it sanctioned sale and financial leaseback transactions. This financing construction and comparable financial transactions, in which the title transfer method is used to provide security, serve viable economic goals and were widely applied in the Netherlands before the introduction of the current Civil Code.

The Supreme Court's decision, however, also has drawbacks. The first subsection below investigates the extent to which the *Sogelease* decision limited the scope of the prohibition of fiduciary transfers of title set out in Article 3:84(3) of the NCC, and to what extent it made fiduciary transfers possible. The second subsection examines what a fiduciary relationship arising from a transfer of title for security purposes should look like after the *Sogelease* decision. Particular attention will be paid to the legal constructions that can be applied in order to guarantee a fair balance between the interests of collateral provider and collateral taker.⁹⁷

a. Are fiduciary transfers of title now possible?

The sale and financial leaseback construction of the *Sogelease* case is a financing construction in which the lessor finances the lessee. The lessee provides the lessor with security by transferring to him outright title to assets that are subsequently leased back to the lessee. In spite of the Dutch prohibition on transferring title for security purposes, the Supreme Court has recognised this construction. According to the Supreme Court, a transfer of title is therefore allowed, even if its main function is the provision of security, so long as a 'true transfer' has taken place. The *Sogelease* decision shows that it is very easy to structure a transaction as a 'true transfer'. The only circumstance that gave the lessor more rights than a secured party (such as a pledgor), was the contractual provision that he could dissolve the agreement upon default; he would then have an unlimited, unconditional right of disposal. According to the Supreme Court, only a transfer of title having all the characteristic features of a right of pledge would be considered invalid under Article 3:84(3) NCC. Arguably, the consequence of this decision is that the scope of the prohibition of fiduciary transfers of title has been considerably limited. The *Sogelease* decision relates to sale and leaseback transactions, but has been formulated in very general terms and can therefore also be considered relevant for other title transfer structures in which, from an economic point of view, security is provided.

97 The impact of the prohibition of fiduciary transfers of title in Article 3:84(3) of the NCC has been discussed extensively in Dutch legal literature. Before the *Sogelease* decision, for example, the following articles appeared: Heyman 1994; Kleijn 1994; Kortmann 1994 II. The *Sogelease* decision was discussed in the following publications, among others: Van Hees 1997; Kortmann / Van Hees 1995 I; Kortmann / Van Hees 1995 II; Reehuis 1997; Reehuis 1998; Rongen 1996; Salomons 1995; Salomons 1996; Struycken 1996 I; Struycken 1996 II; Verhagen 1997. See, more specifically in relation to transactions with financial collateral, the literature mentioned in footnote 116.

The remarkable thing about the Supreme Court's decision is that it now seems possible to put aside the core characteristics of security interests on the basis of a contract. The Supreme Court already seems to assume a 'true transfer' only if the parties agree that the security taker has full title upon default (which is basically the same as an appropriation of the assets involved), and if they agree that the security taker is not obliged to transfer any surplus value to the provider of the security. This is also the greatest weakness of the Supreme Court's decision. Whereas it was good that the Supreme Court sanctioned sale and leaseback constructions and, more generally, fiduciary transfers of title, it should not be possible to put aside the fiduciary relationship arising in the provision of security on the basis of an agreement between the parties. The core characteristics of security interests are generally issues of mandatory law, if only because a balance between the interests of the parties involved in a fiduciary relationship is deemed to be essential. The method applied is not important; the core characteristics of security interests should apply whether security has been provided by way of a right of pledge or by transferring title on a fiduciary basis. It is not desirable that these characteristics be put aside on the basis of a mere agreement. The issue of the contents of the fiduciary relationship is discussed further in the next subsection.⁹⁸

b. The contents of the fiduciary relationship

Kortmann and Van Hees have argued that the *Sogelease* decision is a step back to the time of the *Bierbrouwerij* and *Hakkers / Van Tilburg* decisions of 1929,⁹⁹ in which the Dutch Supreme Court recognised the possibility of fiduciary transfers of title.¹⁰⁰ The main deficiency of these decisions was that the contents of the fiduciary relationship had not yet been established. The interests of collateral provider and collateral taker were to be balanced in a series of Supreme Court decisions in the years to come. Indeed, the *Sogelease* decision has exactly the same drawbacks as the *Bierbrouwerij* and the *Hakkers / Van Tilburg* decisions. The recognition of the possibility of transferring title on a fiduciary basis is positive, but determination of the content of the resulting fiduciary relationship is lacking.

Sigman puts it in even stronger terms. He states:

98 See also section 1.3 above.

99 On these decisions, see section 3.2.2 above.

100 See Kortmann / Van Hees 1995 I; Kortmann / Van Hees 1995 II.

The Court gave financier/lessors far more than they need to secure repayment of monies advanced, and, correlatively, diminished excessively the rights of user/lessees [...].¹⁰¹

This subsection investigates what the fiduciary relationship should look like in the case of fiduciary transfers of title after the *Sogelease* decision. This is done by considering a number of legal constructions that lead to a fiduciary relationship, and by exploring a number of methods that can be applied in order to achieve a fair balance of the interests of the parties involved.

The situation where a party (from an economic point of view) provides security to a counterparty has legal consequences. The parties in a secured transaction are in a special fiduciary relationship, the exact nature of which depends on the way in which the security has been provided. Security can be provided in several ways. It is possible to vest a right of pledge or, if permitted under national law, to transfer title on a fiduciary basis. From an economic point of view, the seller is also secured in the case of a reservation of title. Under Dutch law, the general provision relating to reservation of title (*eigendomsvoorbehoud*) is Article 3:92 of the NCC. The more specific regulation relating to hire-purchase contracts (*huurkoop*) is set out in Articles 7A:1576h-1576x of the NCC. As the *Sogelease* decision shows, other arrangements, such as a sale and financial leaseback construction can also be applied to provide security. Economically, a sale combined with a financial lease (structured as a reservation of title) is essentially a secured loan.¹⁰² What all these arrangements have in common is that, in one way or another, the interests of the secured party and the counterparty are balanced.

Pledge and fiduciary transfer of title

In the case of a pledge or a fiduciary transfer of title, the latter of which was applied under old Dutch law and is currently applied under German law, the core characteristics of security interests apply. The application of these characteristics guarantees a fair balance between the interests of the provider of security and the secured party. Over-endowment of the secured party is prevented in these cases by applying the following rules. Enforcement should take place in such a way that assets are valued on a commercially reasonable basis, which is usually guaranteed by a mandatory sale with a public character, without appropriation of those assets by

101 See Sigman 1996, p. 170.

102 On this latter issue, see, for example, Heyman 1994; Sigman 1996; Reehuis 1997.

the secured party. In addition, any possible surplus value upon enforcement should be transferred to the provider of the security.¹⁰³

Reservation of title and hire-purchase contracts

From an economic point of view, when a seller reserves title, he secures the payment of the sale price by the buyer. The fiduciary relationship between the parties is reflected in the buyer's expectation of ownership, the *Anwartschaftsrecht*. If the buyer defaults, however, the seller can rescind the sale agreement on the basis of Article 6:265 of the NCC and claim the asset transferred from the buyer, with the result that unrestricted title is again vested in the seller. In this case, the position of the buyer is protected by Article 6:271, which obliges the seller, upon rescinding the sale contract, to return payments already made by the buyer. In practice, however, a payment by the seller to the buyer under Article 6:271 of the NCC may well fail to occur because the parties may have agreed upon damages to be paid by the buyer in the event of his default. The buyer may, for example, be liable for any decrease in the value of the assets concerned, as well as any costs that have been made by the seller in connection with the default (claiming back the assets, legal advice, etc.).

Because reservation of title arrangements are essentially security interests, it should be determined whether the core features of security interests that apply in the case of a right of pledge and a fiduciary transfer of title are also applicable in the case of a buyer's default under a reservation of title arrangement. Should the seller conduct a prescribed sale in order to obtain maximum proceeds, without appropriation of the assets involved, and should he pay any surplus value to the buyer? As in a fiduciary transfer of title, the secured party in a reservation of title arrangement (i.e. the seller) has an ownership interest. Even so, in the event of default, there is no complete parallel between fiduciary transfer of title and reservation of title arrangements. Not all of the principles of security interests are applied in the case of a reservation of title arrangement. The fact that the seller has always been the owner of the sold assets is stressed. For this reason, it is generally accepted that the seller is, in this case, not obliged to carry out a prescribed sale. In addition, the prohibition of appropriation is not applied in the case of reservation of title arrangements.¹⁰⁴ Article 3:92 of the NCC does not make it clear whether the seller under a reserva-

103 See sections 1.3, 3.2 and 3.3.2 above.

104 See chapter 10 of Reehuis 1998. See also, however, Zwolve 1995, section 4, who has argued that a seller that has reserved title should – like a pledgee – carry out a prescribed sale in the event of the buyer's default.

tion of title arrangement is under the obligation to pay any surplus value to the buyer upon enforcement. The special regulation of Article 7A:1576t of the NCC relating to hire-purchase contracts, however, requires 'full compensation' of the buyer if, after rescinding a hire-purchase agreement, the seller were to be financially better off than if the agreement had remained intact. This means that the seller should pay back any instalments already paid by the buyer. It can also mean that the seller should compensate the buyer if the assets involved have increased in value.¹⁰⁵

Balancing the interests of the parties

This prompts the question of what the fiduciary relationship should look like in the case of a fiduciary transfer of title under the *Sogelease* decision. It has already been noted above that, according to the Supreme Court, the sale in a sale and financial leaseback transaction leads to a 'real transfer of title'. To what extent does such a real passing of title leave room for mechanisms that balance the interests of the parties to be applied? These mechanisms relate, in particular, to the way enforcement should take place (a prescribed sale), to the prohibition of appropriation, and to the right to a possible surplus value. The Supreme Court's decision, which recognised a contractual provision that gave the secured party an unlimited right of ownership upon default, seems to suggest that these mechanisms can be put aside by simply agreeing that they do not apply. However, such an interpretation favours providers of credit too much, and is detrimental to the providers of security and their creditors. There have, therefore, been several mechanisms outlined in legal literature that can be applied in order to balance the interests of all the parties involved.¹⁰⁶

1. Application of the pledge principles by way of analogy¹⁰⁷

Kortmann and Van Hees have argued that the Supreme Court has excluded the application of the core principles of pledge law to financial sale and leaseback transactions, by way of analogy.¹⁰⁸ In section 3.4.2 of the *Sogelease* decision, the Supreme Court made it clear that the rules of

105 See, in the same sense, Van Hees 1997, section 5.3.

106 See Heyman 1994, p. 10; Kleijn 1994, p. 16; Kleijn's annotation to the *Sogelease* decision, section 5; Kortmann / Van Hees 1995 I, pp. 995-996; Reehuis 1997, p. 60; Rongen 1996, pp. 279-282; Salomons 1995; Salomons 1996; Struycken 1996 I; Struycken 1996 II; Verhagen 1997, p. 56.

107 See sections 1.3, 3.2 and 3.3.2 above.

108 See Kortmann / Van Hees 1995 I, pp. 994-995; Kortmann / Van Hees 1995 II.

pledge law applied to fiduciary transfers of title under old Dutch law. By characterising a transfer under a sale and financial leaseback construction as a 'real transfer' in section 3.4.3, and not as a fiduciary one, the Supreme Court indeed seems to exclude the application of the rules of pledge law. However, as Kortmann and Van Hees also observe, such an interpretation would not do justice to the nature of a sale and financial leaseback transaction, which, from an economic point of view, involves the provision of security and thus leads to a fiduciary relationship between lessor and lessee. In my view, it should therefore be possible to use the provisions of pledge law in order to shape this and comparable fiduciary relationships.

2. Application of Article 7A:1576t of the NCC relating to hire purchase or comparable contracts¹⁰⁹

As far as the seller's obligation to pay any surplus value to the buyer upon default is concerned, there has been a discussion in legal literature about the scope of applicability of Article 7A:1576t of the NCC, which requires 'full compensation' to be paid to the buyer.¹¹⁰ In the context of sale and financial leaseback constructions, Salomons has argued that the *Sogelease* decision does not leave room for the payment of any surplus value by lessor to lessee, whereas Struycken and Van Hees do not feel comfortable with this outcome. Taking into account the fact that the parties to a reservation of title arrangement, a hire-purchase, or a sale and leaseback contract are in a fiduciary relationship (particularly if the buyer/lessee carries the economic risks throughout the transaction), it is desirable for Article 7A:1576t of the NCC to be applied to all the contracts mentioned. The seller/lessor should, upon default by the buyer/lessee, pay the buyer/lessee any surplus value, including that which has arisen due to price fluctuations.¹¹¹

3. Application of the rules relating to unjustified enrichment (*ongerechtvaardigde verrijking*)

Article 6:212 of the NCC sets out an obligation for a person who is enriched at the expense of another to repair the damage up to the amount of his enrichment, to the extent that this is reasonable. In the event that a

109 On the basis of Article 7A:1576h(2) of the NCC, the rules relating to hire-purchase contracts also apply to contracts that have the same purpose.

110 See the subsection on reservation of title and hire-purchase contracts above.

111 See Salomons 1995; Salomons 1996; Struycken 1996 I; Struycken 1996 II; Van Hees 1997, section 5.3.

secured party appropriates or sells a security provider's assets without paying any surplus value to the security provider, the secured party is enriched at the cost of the security provider and his other creditors. Arguably, this enrichment cannot be justified because it is not in line with the fiduciary relationship between the security provider and security taker, which requires a balance of their interests. The enrichment should, in this view, result in the payment of damages by the security taker.¹¹²

4. Application of the principle of fairness and reasonableness¹¹³

It can also be argued that the appropriation or a sale of encumbered assets by a secured party, without payment of any surplus value to the security provider, is not fair and reasonable. Withholding surplus value is detrimental to the security provider and particularly also to the creditors of the security provider. In light of the principle of fairness and reasonableness, it is therefore arguable that the contractual relationship between the security provider and the security taker entails an obligation for the security taker to part with any surplus value.¹¹⁴

5. Application of the rules relating to voidable preference (*actio pauliana*)

Under certain circumstances, particularly if a contract appears to have been concluded against the interests of other creditors, the rules relating to voidable preference (*actio pauliana*) may also be applicable.¹¹⁵

These rules are applications of the general principle that parties to an agreement should behave in a fair and reasonable manner towards each other. If the parties are in a fiduciary relationship, in particular, it is important to reach a fair balance between the interests of the parties on the basis of one of the mechanisms outlined above. This is even more important if there is an unequal balance of power between the parties. In this case, the application of the pledge principles is crucial in order to protect

112 In this sense, see Heyman 1994, p. 10; Kortmann / Van Hees 1995 I, p. 996; Verhagen 1997, p. 56.

113 See, for example, Articles 6:2 and 6:248 of the NCC.

114 In this sense, see Heyman 1994, p. 10; Kortmann / Van Hees 1995 I, p. 996; Verhagen 1997, p. 56.

115 See Article 3:45 *et seq.* of the NCC and Article 42 *et seq.* of the NBC. In this sense, see Kortmann / Van Hees 1995 I, p. 996; Verhagen 1997, p. 56.

the weaker party, usually the security provider, against a more powerful counterparty.

3.4.3 *The Sogelease decision and repo and securities lending agreements*

The *Sogelease* decision relates to a sale and financial leaseback construction, but it has been formulated in general terms and can therefore also be considered relevant to outright transfers of collateral in the course of repo and securities lending transactions. This section considers whether such collateral transfers should be recharacterised under Article 3:84(3) of the NCC. The main arguments for and against the applicability of this provision to transfers of financial collateral are discussed below in light of the *Sogelease* decision. In line with the analysis in section 3.4.1 above, the following issues are considered: (1) the rights of a collateral taker upon default, (2) which party carries the economic risks and benefits in a financial collateral arrangement and (3) whether the parties to such an arrangement envisage any goals other than the provision of security.¹¹⁶

a. Rights upon default

If default occurs in relation to the collateral provider, the goals of the close-out netting procedure under the GMRA or GMSLA are similar to the enforcement of a right of pledge. Although the collateral taker is not obliged to sell the financial collateral involved, the procedure of valuation set out in the GMRA and GMSLA has the same objective as a public sale: i.e. obtaining the best available market price for the collateral. After the valuation of all obligations in a single currency, set-off takes place. The result is a single net amount payable by one of the parties. This essentially means that any surplus value must be refunded. The close-out netting mechanism, which applies upon default in a financial collateral arrangement, is therefore in line with the core principles of security interests outlined in the general introduction to this chapter. It gives shape to the recovery function of financial collateral and points in the direction of a security interest.¹¹⁷

116 On the issue of financial collateral and recharacterisation risk, see also Buist and Roos 1994; Van Setten in Dalhuisen / Van Setten 2003; Graaf 1994/1995; Graaf 1995/1996; Graaf and Van IJlzinga Veenstra 1996/1997; Graaf / Trip 1997/1998; Graaf 1998/1999; Keijser 2001 II; Keijser 2002 II; Keijser 2004; Rank 1998 I; Rank 1998 II; Rank 2000; Rongen 1996; Schroeder 1997; Strik 1998; Verhagen 1997.

117 See also section 4.7 of chapter II and section 3.3.3.b of this chapter.

b. *Economic risks and benefits*

Another factor that can shed some light on the question of whether title has been transferred or a security interest has been established is an analysis of which party carries the economic risks and benefits in a transaction with financial collateral. The economic risk profile can be assessed by looking at the agreement between the parties in respect of margin maintenance methods, income payments and voting rights.

In the course of a transaction, the parties are usually under an obligation to pay margin in accordance with one of the different *margin maintenance methods* described in section 4.3 of chapter II. In effect, this means that the party who was originally entitled to the transferred collateral carries the risks and enjoys the benefits of any changes in its value. If prices go up, a part of the collateral will be returned. If prices go down, additional collateral must be provided. The economic risk of price movements is therefore vested in the original title-holder.

As discussed in section 4.5 of chapter II, under the GMRA or GMSLA, an amount equal to *income payments* is, as a rule, transferred by the transferee of securities to the original title-holder. In this respect, the original title-holder thus continues enjoying the economic benefits of the securities transferred.

The *voting rights* in respect of securities transferred in a repurchase or securities lending transaction are another indicator that can be used to establish which party carries the economic risks of a transaction. This issue only plays a role in the case of equity transactions. The approach of the GMRA and the GMSLA differs with regard to this issue. In line with paragraph 3.6 of the GMRA Equities Annex, the main rule is that the original title-holder can give voting instructions that have to be carried out by the transferee of equity securities. The approach of paragraph 6.3 of the GMSLA, on the other hand, is that the transferee of securities is, as a rule, not obliged to execute voting rights in line with the instructions of the original title-holder, but can act in accordance with his own views. The voting rights are thus, as a rule, enjoyed either by the transferee (securities lending) or by the original title-holder of securities (repo).¹¹⁸

118 On voting rights and recharacterisation risk, see also Corrigan / Georgiou / Gollow 1999, pp. 130-131.

It should be stressed that these arrangements in respect of margin, income payments and voting rights are all of a contractual nature. As such, they have no direct impact in the field of property law, i.e. on the question of whether the parties should have opted for a security interest or an outright transfer of title. These contractual arrangements can nevertheless play a role in establishing the real intentions of the parties. If all risks and benefits are assumed by collateral taker, this points to a full transfer of title. If, on the contrary, the original title-holder carries all risks and benefits, there is a possibility that the parties have only envisaged a recovery function for the assets involved, and should actually have established a security interest.¹¹⁹

c. Motivations other than security

It cannot be denied that, among other things, transfers of collateral under repo and securities lending transactions have a recovery function. The transferee's rights in respect of the collateral transferred are, however, not merely limited to having recourse to the proceeds of collateral upon default; the transferee acquires full and unrestricted title to the collateral. The transferee is therefore entitled to dispose of the collateral as he deems fit. He is not obliged to deliver the same securities at the end of a transaction; he has only an obligation to deliver equivalent securities. These are the decisive circumstances that both prevent recharacterisation on the basis of Article 3:84(3) NCC and explain the reason for choosing the title transfer method. Under general principles of Dutch (and German) law, a general right of disposal (combined with a duty to transfer equivalent assets at a later date) cannot be based on a security interest.¹²⁰ It is for this reason that the title transfer method is traditionally used to provide collateral under repos and securities lending transactions.¹²¹

It is precisely the collateral taker's right of disposal and the tradeability function of financial collateral that distinguish repo and securities lending agreements from traditional security interests. Under a traditional security interest, the secured party has no unlimited right of disposal. A

119 See also section 3 3 3 above

120 On this issue, see also section 4 of chapter IV

121 In this sense, see Van Ardenne-Stachiw 1995, section 2 6 9 and chapter 5, Schroeder 1997, Verhagen 1997, Seinstra 1998, Keijser 2002 II; Van Setten in Dalhuisen / Van Setten 2003, section 8 For example, Rank 1998 I; Rank 1998 II, and Graaf 1998/1999 are more careful, but in my view they underestimate the crucial role of the tradeability function of financial collateral See also section 3 3 3 above

pledgee can only dispose of pledged assets when the pledgor does not fulfil the secured obligation. A fiduciary owner does not have the right to freely dispose of the assets transferred unless default occurs.¹²² Likewise, in a sale and financial leaseback construction (similar to that in *Sogelease*), a lessor has no general right of disposal in respect of the assets transferred and leased during the course of a transaction because the lessee has an ownership expectation that the lessor is not allowed to neglect.

Nonetheless, it should be noted that article 3:84(3) NCC may be applicable if the parties have explicitly excluded the tradeability of the financial collateral provided and if the documentation between the parties also makes it clear that the collateral is transferred for recovery purposes only. Indicators of such intentions may, for example, be a transfer of highly non-liquid collateral securities that are obviously not tradable, or a provision in an agreement that collateral securities must be kept on an individualised basis in a safe or a separate account for the duration of the transaction.¹²³

3.4.4 *The BTL Lease decision*

Recently, the Dutch Supreme Court was faced a second time with a sale and leaseback arrangement. In its *BTL Lease* decision of 18 November 2005,¹²⁴ the Supreme Court paid more attention to the position of the collateral provider.

In this case, a number of interrelated companies needed money in order to pay lease terms due to BTL Lease under an operational lease agreement. In order to obtain this money, they sold a number of trucks and trailers to BTL Lease and subsequently leased them back. Under the terms of this latter lease, the companies were supposed to pay three lease instalments and had the option to buy the trucks and trailers at the end of the lease period. What is noteworthy about this case is that the trucks and trailers were sold for approximately NLG 350,000, whereas their market value was approximately NLG 700,000.

122 E.g., in the *Bierbrouwerij* case, Heineken (the fiduciary owner) was only allowed to dispose freely of the furniture of the counterparty in the event of the latter's default

123 On the recovery and tradeability functions of financial collateral, see also section 2.4 of chapter II and section 3.3.3 of this chapter.

124 See case number LJN AT8241 at www.rechtspraak.nl

When the companies ran into economic difficulties, some of the trucks and trailers disappeared, allegedly sold by one of the companies' directors. BTL Lease sued this director and – as owner of the trucks – claimed approximately NLG 350,000 on the basis of tort (unauthorised disposal). The director (and later his heirs) countered that BTL Lease was not the owner at all, because the sale and leaseback was entered into for security purposes only, and was thus essentially a fiduciary transfer. Because such transfers are forbidden under Dutch law, the director (and his heirs) claimed ownership. One of the main arguments that, in their eyes, pointed to a fiduciary and not an outright transfer, was that there was a clear discrepancy between the market value of the trucks and trailers and the sale price paid by BTL Lease.

Following testimony in which it was stated that the only purpose of the parties was to establish a security interest for a loan, the district court (*rechtbank*) rejected BTL's claim. The court of appeal (*hof*) basically stated that BTL had to prove that it was the owner, and rejected its claims because it had not successfully done so. The Supreme Court annulled this decision on the basis of the legal rules relating to proof. According to the Supreme Court, it was not BTL that had to prove that an outright transfer had taken place, but the director (and his heirs) who had to prove that the transfer was a fiduciary one. On this basis, the Supreme Court referred the case back to another court of appeal. It is interesting to note that the Supreme Court also shed some light on the substantive issue at stake, i.e. whether the transfer should be qualified as outright or fiduciary. The Court explicitly stated that an imbalance between sale price and market value may be taken into account in this respect, and made it clear that the disproportion between the market value of the property (in this case NLG 700,000) and the sale price paid (NLG 350,000) may well indicate that the property has been transferred for recourse purposes, and that the parties should actually have established a right of pledge.

3.4.5 Conclusion

As of 1992, Article 3:84(3) of the NCC has prohibited fiduciary transfers of title. The *Sogelease* decision of the Dutch Supreme Court interpreted this prohibition and considerably limited its scope. One may conclude from the *Sogelease* decision that only title transfers that have been entered into solely for recovery purposes are affected by this provision. The fact that the Supreme Court has recognised the sale and financial leaseback construction as a viable financing structure is positive. The *Sogelease* decision

has been formulated very generally and leaves room for other financing mechanisms involving a fiduciary transfer of title. The decision, however, also has a major drawback. It pays hardly any attention to the position of collateral providers. No balance is struck between the interests of collateral providers, their creditors and collateral takers. The fiduciary relationship arising from the provision of security from an economic point of view has not been clearly defined. In the recent *BTL Lease* case, which featured a clear discrepancy between market value of assets and sale price paid, the Supreme Court has somewhat refined its position.

The prohibition of fiduciary transfers of title in Article 3:84(3) of the NCC has given rise to continued doubts in the repurchase and securities lending market, stemming from the fact that financial collateral serves a recovery function. The fact that genuine collateralised transactions also envisage the tradeability of the collateral transferred (including margin collateral), is, however, sometimes underestimated as a decisive factor that necessitates the use of the title transfer method. If the parties to a financial collateral arrangement actually intend to include both the recovery and tradeability functions, Article 3:84(3) of the NCC will not be applicable. In accordance with the function-based approach set out in section 3.3 above, a title transfer of financial collateral will, in this case, be valid and will not be recharacterised as a security interest.

At the same time, market participants should accept that the interests of collateral providers, their creditors and collateral takers should be balanced if a transaction is entered into for recourse purposes only. Mechanisms to this end include, for example, a prescribed sale that guarantees maximum proceeds, an obligation to transfer a possible surplus value after enforcement or any comparable mechanism. Such mechanisms should, in particular, be applied if a transaction is entered into for recourse purposes between parties who are not in an equal power position. Under such circumstances, it is fair to apply core principles of security interests in one way or another and, if necessary, to recharacterise a transfer of title as a security interest. This 'risk' for collateral takers (i.e. a level of protection for collateral providers) cannot and should not be eliminated.

3.5 Subsidiary right of pledge

In order to eliminate any uncertainties in relation to transfers of financial collateral under Article of the 3:84(3) of the NCC, practicing lawyers have

developed two solutions. The first is to transfer securities under a law other than that of the Netherlands (in the books of Euroclear or Clearstream, for example) in order to evade the applicability of Dutch property law altogether. This approach relates to private international law and will not be discussed here.¹²⁵ The second solution, which is the topic of this section, is the establishment of a subsidiary right of pledge.¹²⁶

In my view, a subsidiary right of pledge as a fall-back provision is superfluous in genuine repo and securities lending transactions. As argued above, if the parties meet the dual function requirement (recovery and tradeability) that is envisaged as a standard in, for example, the GMRA and the GMSLA, no recharacterisation will take place. Only if the parties have deviated from the provisions of internationally recognized standard agreements and have excluded the tradeability of financial collateral, can a subsidiary right of pledge be of value. Because a transfer solely for recovery purposes is not enforceable under Article 3:84(3) of the NCC, in this case the subsidiary pledge provision can take effect.

A Dutch right of pledge is only enforceable if certain formal requirements have been met, such as the provision of actual possession, or, in the case of a non-public right of pledge, the drawing up of an authentic deed or a registered private instrument.¹²⁷ If the parties agree to establish a subsidiary right of pledge, they should ensure that these formal requirements are indeed complied with.

There is a drawback, however, to vesting a subsidiary right of pledge. A judge may interpret such a provision as an indication of the actual intention of the parties not to transfer outright title to collateral, but to vest a security interest. This is the approach of English law.¹²⁸ For a more liberal approach under American law, refer to Paragraph 6 of the TBMA Master Repurchase Agreement, which envisages the establishment of a subsidiary security interest.

125 On this issue, see, for example, Rank 1997; Rank 1998 I, pp 28-30, Graaf 1998/1999

126 The solution of a subsidiary right of pledge was first suggested in Buist and Roos 1994. See also Rank 1998 I, pp 25-28

127 See Articles 3:236, 237 and 239 of the NCC. Consider also Articles 20 and 42 of the SGTA, which require a book-entry for the establishment of a right of pledge in respect of a share in a pool of SGTA securities (*verzameldepot* or *girodepot*)

128 See Rank 1998 I, p 28, Graaf 1998/1999, p 193.

Note that the establishment of a subsidiary right of pledge has largely been abandoned as far as repo agreements are concerned. Whereas the Netherlands Domestic Annex to the GMRA 1995 originally did envisage a subsidiary right of pledge,¹²⁹ such a right was not considered necessary after the introduction of Article 2a of the STSA in January 1999.¹³⁰ The Dutch Domestic Annexes of October 2000 to the 1995 and 2000 versions of the GMRA, therefore, no longer contain a subsidiary right of pledge. Nonetheless, in securities lending agreements, a subsidiary pledge in respect of collateral and margin collateral securities is often still envisaged in the documentation between the parties.¹³¹

3.6 Article 2a of the STSA

3.6.1 Introduction

The importance of repos for De Nederlandsche Bank (DNB) and the feeling of unease among market participants about possible risks under Article 3:84(3) of the NCC led to the introduction of Article 2a of the STSA. This provision was intended as an interpretation of Article 3:84(3) of the NCC and makes it clear that there is no recharacterisation risk in respect of repos under Dutch law. Article 2a of the STSA has largely been introduced for psychological reasons and is actually a superfluous provision. Before the introduction of this provision, transfers of financial collateral were already safe under Dutch law if they met the dual function requirement.¹³² Article 2a of the STSA has been in effect since 1 January 1999 and forms part of a broader project to prepare the Netherlands for the introduction of Stage Three of the Economic and Monetary Union (EMU).¹³³

Article 2a of the STSA states:

129 See section 2(l) of the Annex dated 16 March 1998.

130 See section 3.6 below for a more detailed discussion of Article 2a STSA.

131 See also section 3.6.7 below.

132 See sections 3.3.3 and 3.4.3 above.

133 See section 7 of chapter II on the use of repos by central banks. The ECB, when asked for an opinion on the introduction of Article 2a of the STSA, welcomed clarity about the enforceability of repurchase agreements under Dutch law in light of the central role of repurchase transactions in the monetary policy framework of the ESCB. See the letter of W. Duisenberg (President of the ECB) to G. Zalm (Dutch Minister of Finance) of 16 October 1998, mentioned in *Tweede Kamer*, 1998-1999, 26 124, no. 5, p. 1. See also DNB 1998 I, pp. 23-24; DNB 1998 II, p. 21; DNB 1998 III, pp. 145-146.

The circumstance that the buyer of securities has agreed, upon making the purchase, to subsequently transfer an equal quantity of securities of the same type to the seller, does not mean that, in violation of Article 3:84(3) of the Civil Code, the purpose of the purchase is to transfer property as a security device or that the intent to transfer property into the estate of the transferee is absent, unless the securities remain in the hands of the seller after the transfer.¹³⁴

This section critically evaluates Article 2a of the STSA. First, the scope of Article 2a of the STSA is discussed. Does this provision relate to 'genuine' repos only, or is it also applicable to fiduciary transfers of title (section 3.6.2)? Does Article 2a of the STSA apply to both purchased and margin securities (section 3.6.3), to securities lending transactions (section 3.6.4) and to other collateralised transactions (section 3.6.5)? Subsequently, the focus is on the question of how hold-in-custody arrangements should be seen in light of Article 2a of the STSA (section 3.6.6). The deletion of the subsidiary right of pledge from the Netherlands Annex to the GMRA upon the introduction of Article 2a of the STSA is also discussed (section 3.6.7). Note that Article 2a of the STSA is repealed in Article IV of the Dutch law implementing the Collateral Directive.¹³⁵

3.6.2 *Genuine repos only*

This section examines the scope of Article 2a of the STSA. Do only 'genuine' repo transactions fall within its scope (i.e. transactions in which financial collateral fulfils the two functions of tradeability and recovery)? Or does it also apply to fiduciary transfers of title in which the parties envisage a recovery function only? The wording of Article 2a of the STSA seems to suggest that the first interpretation is the right one.

The words 'an equal quantity of securities of the same type' in Article 2a of the STSA suggest that a repo must serve more functions than recovery alone. Only if the transferee of securities has the power to dispose of these securities as he pleases, can he be under an obligation to transfer

134 Translation: Rank 2000, p. 17. Original Dutch text: 'De omstandigheid dat de koper van effecten zich bij de koop heeft verbonden tot een latere overdracht van een gelijke hoeveelheid effecten van dezelfde soort aan de verkoper, brengt niet met zich dat die koop, in strijd met artikel 84, derde lid, van Boek 3 van het Burgerlijk Wetboek, ten doel heeft de effecten over te dragen tot zekerheid of de strekking mist de effecten na de overdracht in het vermogen van de koper te doen vallen, tenzij de effecten na de levering in handen van de verkoper blijven.'

135 On Article 2a STSA, see Broekhuizen 1998; Rank 1998 II, particularly section 6; Seinstra 1998; Graaf 1998/1999, particularly section 4.3; Nederveen 1999, pp. 249-251; and Rank 2000.

equivalent securities at the end of a transaction. Tradeability, as outlined above, is the second characteristic function of financial collateral in addition to the recovery function. It can therefore be concluded that Article 2a of the STSA applies to genuine repos only.

A second phrase that points in this direction is 'unless the securities remain in the hands of the seller after the transfer'. With this formula, the legislator intended to prohibit a delivery *constituto possessorio*.¹³⁶ But why should the legislator wish to forbid a manner of delivery that is explicitly allowed in Article 3:115a of the NCC? In my view, this is because the legislator had in mind the concept of delivery *constituto possessorio* that was customarily used to effect a fiduciary transfer of title under old Dutch law and which is still applied to the same end under current German law.¹³⁷ Consciously or unconsciously, the legislator probably realised that genuine repos and fiduciary transfers of title are distinct financial transactions with different goals. It seems that the legislator wanted to make sure that genuine repos were protected under Dutch law but did not want Article 2a of the STSA to apply to fiduciary transfers of title.¹³⁸

3.6.3 Purchased and margin securities

The text of Article 2a of the STSA suggests that this provision applies only to purchased securities, while no reference is made to margin securities. After the publication of critical comments by legal practitioners,¹³⁹ the Minister of Finance wrote a letter to Parliament¹⁴⁰ stating that part of the parliamentary documents regarding margin securities had been erroneously omitted and that Article 2a of the STSA should be interpreted as if margin transfers had also been covered by this provision.

An additional problem in this respect is that Article 2a of the STSA has unnecessarily been limited to the *causa* of a sale (*koop*), whereas under

136 See *Tweede Kamer*, 1997-1998, 26 124, A, point 2

137 See sections 3 2 2 and 3 2 3 above

138 If this had indeed been the intention of the legislator, it would have been better to explicitly exclude fiduciary transfers that serve a recovery function only, instead of prohibiting a method of delivery (*constitutum possessorium*). It is better to focus on content than on method of delivery. Fiduciary title can also be transferred on the basis of another type of delivery, such as a physical delivery of the assets involved, whereas, on the other hand, a delivery *constituto possessorio* does not necessarily mean that a fiduciary transfer takes place, it can also lead to an outright transfer of title

139 See Broekhuizen 1998, Rank 1998 II, section 6, Graaf 1998/1999, section 4 3

140 See *Tweede Kamer*, 1998-1999, 26 124, no. 7

Article 3:84(3) of the NCC other *causae* also cannot serve as a basis for a transfer for recovery purposes.¹⁴¹ Purchased securities in a repo are indeed transferred on the basis of a sale, but the requirement of a sale is somewhat problematic in relation to margin securities. It is more likely for the transfer of margin securities to take place on the basis of the concept of replaceability than on the basis of a sale.¹⁴² However, taking into account the intent of Article 2a of the STSA to facilitate a well-functioning repo market, and given the letter of the Minister of Finance, Article 2a of the STSA must also be considered to apply to transfers of margin securities.

3.6.4 Securities lending transactions

The parliamentary history does mention securities lending contracts as contracts to which Article 2a of the STSA applies.¹⁴³ Still, the wording of Article 2a of the STSA and the requirement of a *causa* in the form of a sale agreement are unsatisfactory in this respect. The wording of Article 2a of the STSA is not in line with securities lending terminology; e.g., reference is made to buyer (*koper*) and seller (*verkoper*) and not to borrower and lender.

In addition, the limitation to the *causa* in the form of a sale agreement is, as in the case of margin transfers under repo transactions, problematic in relation to securities lending transactions. The parliamentary history states that *loaned securities* under a securities lending transaction should be transferred on the basis of a sale in order to be covered by Article 2a of the STSA.¹⁴⁴ This statement is not accurate for two reasons. First, in practice, loaned securities are customarily transferred on the basis of a loan of fungibles (*overeenkomst van verbruiklening*) and not on the basis of a sale agreement.¹⁴⁵ Second, in securities lending transactions, the flows of *collateral and margin collateral* in particular, and not the loaned securities, are potentially threatened by Article 3:84(3) of the NCC. In spite of this, it is likely that the legislator intended the requirement of a *causa* in the form of a sale agreement to be applied to collateral and margin collateral securities as well. In practice, however, collateral securities are often

141 See *Tweede Kamer*, 1997-1998, 26 124, A, section 2; and *Tweede Kamer*, 1998-1999, 26 124, no. 5, section 3.

142 See section 2.6 above.

143 See *Tweede Kamer*, 1998-1999, 26 124, no. 5, section 3.

144 See *Tweede Kamer*, 1998-1999, 26 124, no. 5, section 3.

145 See section 2.4 above.

transferred on the basis of a loan of fungibles.¹⁴⁶ Title also passes in the case of margin securities, but it is unlikely that this occurs on the basis of a sale. It is more likely for a transfer of margin securities to take place on the basis of the concept of replaceability.¹⁴⁷ Article 2a of the STSA and its explanatory comments are not satisfactory in this respect.

3.6.5 Other collateralised transactions

It follows from the above that Article 2a of the STSA concerns repos and, possibly, securities lending transactions. It is not directly applicable, however, to a transfer of margin securities under the ISDA Credit Support Documents or under the subsequent May 2001 ISDA Margin Provisions. The same holds true for transfers of securities under cross-product arrangements.¹⁴⁸ Therefore, if parties transfer securities under derivatives or cross-product arrangements, the risk that this transfer will be recharacterised as a security interest must primarily be determined on the basis of the scope of Article 3:84(3) of the NCC as interpreted in the *Sogelease* decision. The legislator deemed it necessary to confirm that transfers of financial collateral under repo (and securities lending) transactions are safe under Dutch law, but the fact that Article 2a of the STSA is limited to these financial products only and does not apply to comparable financial arrangements is an oversight, which has led to the question of whether Article 2a of the STSA can be applied by way of analogy. In my view, there is nothing against an application by way of analogy to flows of collateral under financial instruments comparable to repos, although it does not have added value. The risk profile for transactions with financial collateral is arguably the same under Article 3:84(3) of the NCC (as interpreted in the *Sogelease* case) and Article 2a of the STSA.

146 See section 2.4 above.

147 See section 2.6 above.

148 A cross-product example: seller X owes margin securities to buyer Y under a repo transaction (in principle, Article 2a STSA applies to a transfer of such margin securities). At the same time, Y decides to provide X with securities of the same type in the course of margin obligations under a derivatives transaction (such transfer is not covered by Article 2a STSA). If these obligations are netted under a bridge provision to that end, or under the European Master Agreement (see section 5 of chapter II), the protection of Article 2a of the STSA may no longer apply to the transfer of the net amount of margin securities, as the text of Article 2a of the STSA is limited to repo transfers only.

3.6.6 *Hold-in-custody transactions*

According to the last phrase of Article 2a of the STSA, this provision is applicable 'unless the securities remain in the hands of the seller after the transfer'. In legal literature, the question as to how this phrasing should be read in connection with so-called 'hold-in-custody transactions' has been posed. In a hold-in-custody transaction, the transferor of securities (e.g. a bank) books securities from his own account to an account that the transferee holds with that transferor and which is administered by that transferor. Such book-entry transfers of securities often occur in modern practice, for example, in relation to securities that are subject to the Securities Giro Transfer Act 1995. Hold-in-custody arrangements are compatible with Article 2a of the STSA, if the last words of this provision do indeed actually mean 'unless the parties intend a fiduciary transfer of the securities', as was suggested in section 3.6.2 above. The situation in which securities are held in custody (and therefore, in a sense, remain in the hands of the seller) does not necessarily mean that a fiduciary transfer has taken place. It is certainly possible that the securities involved are, in this case, transferred outright. Whether this is indeed the case should be determined on the basis of the actual intentions of the parties.¹⁴⁹

3.6.7 *The Netherlands Annex to GMRA 1995 and GMRA 2000: deletion of the subsidiary right of pledge*

The Netherlands Domestic Annex to the GMRA 2000 of October 2000 does not contain a subsidiary pledge in relation to transferred purchased and margin securities, as was the case in the earlier Netherlands Domestic Annex to the GMRA 1995. Note that the subsidiary pledge has also been deleted from the current version of the GMRA 1995 Netherlands Annex. This amendment to the Netherlands Annex, which was developed by major market participants in the Netherlands in conjunction with the ISMA, demonstrates that after the introduction of Article 2a of the STSA, market participants were firmly of the view that neither transfers of purchased securities nor transfers of margin securities in a repo run the risk of being recharacterised under Article 3:84(3) of the NCC. In a genuine repo as well as in a properly structured securities lending trans-

149 See Paragraph 4 of the Netherlands Annex of October 2000 to the GMRA 2000 and Section 3 of the Guidance Notes thereto. On this issue, see also Rank 1998 II, pp. 416-417; Rank 2000, p. 17. See also *Tweede Kamer* 2002-2003, 28 874, no. 3, p. 8; *Tweede Kamer* 2004-2005, 30 138, no. 3, p. 10.

action in which financial collateral serves both characteristic functions, a subsidiary right of pledge is indeed superfluous.¹⁵⁰

3.6.8 Conclusion

Article 2a of the Securities Trade Supervision Act 1995, which came into force on 1 January 1999, was intended to protect transfers of financial collateral in repo transactions against the possible applicability of Article 3:84(3) of the NCC. This provision was superfluous because transfers of financial collateral under genuine repos run no risk of being recharacterised as a security interest under Article 3:84(3) of the NCC (as interpreted by the Supreme Court in the *Sogelease* decision). In addition, Article 2a of the STSA had a number of drawbacks; in particular, the scope of its applicability was unclear. Even though it is clear that the legislator also intended the provision to apply to transfers of margin in repurchase transactions and to transfers of collateral under securities lending arrangements, the terminology used in this respect is deficient. Other arrangements involving financial collateral, such as derivatives and cross-product arrangements, were not mentioned at all. Article 2a of the STSA has been rescinded by Article IV of the law implementing the Collateral Directive.¹⁵¹ The risk of recharacterisation is now addressed in Article 7:55 of the NCC, which is an implementation of Article 6 of the Collateral Directive. These latter provisions will now be discussed in section 3.7.

3.7 The Collateral Directive

3.7.1 Article 6 of the Collateral Directive

Article 6 of the Collateral Directive requires that 'a title transfer financial collateral arrangement can take effect in accordance with its terms' under the laws of the Member States of the European Union. With this provision, the European legislator intended to take away the recharacterisation risk in title transfer structures, which should, according to the European legislator, not be recharacterised as security interests. This goal is set out clearly in recital 13 of the Collateral Directive:

150 See also section 3.5 above.

151 See also the Explanatory Comments (*Memorie van Toelichting*) to this provision in *Tweede Kamer*, 2002-2003, 28 874, no. 3, p. 8 and p. 24; and *Tweede Kamer*, 2004-2005, 30 138, no. 3, p. 10 and p. 25.

This Directive seeks to protect the validity of financial collateral arrangements which are based upon the transfer of the full ownership of the financial collateral, such as by eliminating the so-called re-characterisation of such financial collateral arrangements (including repurchase agreements) as security interests.

Article 6 of the Collateral Directive protects title transfers. It is, however, unclear whether this provision sanctions only outright transfers (envisaging both functions of recovery and tradeability) or fiduciary transfers of title (intended for recovery purposes alone) as well.

Without a doubt, an outright transfer of title that envisages both a recovery and a tradeability function falls within the scope of the Collateral Directive and is protected by Article 6. In the case of an outright transfer, the financial collateral provided is not merely an object for recourse (recovery function), but it is also used by the parties in order to enter into further trading (tradeability function). These two functions cannot, under general rules of property law, be established by vesting a security interest, such as a right of pledge or a fiduciary transfer of title. Such outright transfers take place in, for example, repurchase, securities lending and derivatives transactions.¹⁵²

It is, however, questionable whether Article 6 also protects fiduciary transfers of title or disguised security interests. Where the rights of a transferee of collateral are limited to having recourse upon the default of the collateral provider, while he does not have the right to dispose of the transferred assets under normal circumstances, such a transfer is actually a security interest.

What would be the effect of including security interests, such as fiduciary transfers of title, within the scope of the Collateral Directive? The most important consequence of applying the directive to secured loans would be that the mechanisms protecting collateral providers would be rendered inapplicable. The Collateral Directive requires a title transfer to take effect 'in accordance with its terms'. This means that the parties to a collateral arrangement can contractually exclude the applicability of the core characteristics of security interests that were outlined in section 1.3 above. Normally, the application of principles such as the prescribed manner of enforcement (e.g., a public sale), the prohibition of appropriation, and the collateral taker's obligation to pay any surplus value to the collateral provider is mandatory. By introducing the possibility of excluding these

152 See also sections 2.4 and 8.3 of chapter II.

principles on the basis of a contract, the balance between the collateral provider and the collateral taker runs the risk of being distorted. A broad application of the Collateral Directive, including fiduciary transfers of title, would particularly favour collateral takers who are in a strong position to negotiate the terms of the collateral agreement. Such a broad application would be particularly harmful in the relationship between a powerful financial institution and a less powerful entity in need of credit, such as a small or medium-sized enterprise. For this reason, it is arguable that Article 6 of the Collateral Directive should apply only to financial collateral arrangements that fulfil the dual function requirement, and not to transactions that essentially entail the establishment of a security interest.

There are additional reasons for restricting the application of the Collateral Directive in this way. First, it is compatible with the standard documentation used for collateralised transactions, in which the two functions of financial collateral are always present. Second, a restrictive approach is in line with the economic, liquidity-enhancing function that financial collateral fulfils. Only when both collateral provider and collateral taker are entitled to dispose of cash and/or securities received will the liquidity of the financial markets be truly enhanced. The scope of the Collateral Directive will be discussed further in section 3 of chapter VI.

3.7.2 *Implementation in the Netherlands*

Article 6 of the Collateral Directive has been implemented in Dutch law by way of Article 7:55 of the NCC, which states:

A transfer under a title transfer financial collateral arrangement is neither a juridical act which is intended to transfer property for purposes of security nor does it lack the effect of vesting title in the acquirer, after transfer, in the sense of Article 84(3) of Book 3. The rules of pledge law are applicable neither directly nor by way of analogy to such an arrangement or to the enforcement thereof¹⁵³

Article 7:55 of the NCC sanctions title transfers of financial collateral. As in the case of Article 6 of the Collateral Directive, it is clear that Article 7:55 of the NCC sanctions outright transfers of title in the course of

153 Translation TK Original Dutch text 'Een overdracht ter nakoming van een financieelzekerheidsovereenkomst tot overdracht is geen overdracht tot zekerheid of een overdracht die de strekking mist het goed na de overdracht in het vermogen van de verkrijger te doen vallen in de zin van artikel 84 lid 3 van Boek 3. De regels betreffende pandrecht zijn op een zodanige overeenkomst en de uitvoering daarvan niet van toepassing of overeenkomstige toepassing.'

repurchase, securities lending and derivatives transactions. In the Explanatory Comments to the implementing law, the Dutch legislator makes a distinction between traditional security interests (such as a right of pledge or a fiduciary transfer of title) and security provided in the course of the financial collateral arrangements mentioned. The legislator does not state this explicitly, but in my view collateral provided under financial collateral arrangements is distinct from that provided under traditional security interests because it serves the two functions of recovery and tradeability. These two functions precisely guarantee that a transfer is outright and does not fall within the scope of Article 3:84(3) of the NCC.¹⁵⁴

It is not certain, however, whether a fiduciary transfer of title, which serves a recovery but not a tradeability function, can also be classified as a financial collateral arrangement in the sense of the Dutch implementing law, and whether such a transfer falls within the scope of Article 7:55 of the NCC. The definition of 'financial collateral arrangement' in Article 7:51 a-c of the NCC leaves room for both a narrow and a broad interpretation in this respect. As was discussed above, fiduciary transfers of title as they existed under the old Dutch Civil Code are currently forbidden under Article 3:84(3) of the NCC, but after the *Sogelease* decision of the Dutch Supreme Court, little remains of this prohibition of fiduciary transfers. A broad interpretation of the term 'financial collateral arrangement', including fiduciary transfers of title, would in effect mean re-introducing the fiduciary transfer of title in Dutch law. Is this desirable? In this respect, it is particularly important to note that Article 7:55 explicitly excludes the applicability of the rules of pledge law. This means that – contrary to old Dutch law¹⁵⁵ – principles such as the prescribed manner of enforcement, the prohibition of appropriation and the collateral taker's obligation to pay any surplus value to the collateral provider are not applicable. Under Article 7:55 of the NCC, it would be possible to exclude these principles on the basis of a contract, which clearly undermines the balance between a collateral provider and a collateral taker that is characteristic of a fiduciary relationship. This is particularly harmful in the relationship between a powerful provider of credit and a small or medium-sized entity in need of financing. In a fiduciary relationship, it is not desirable to exclude the applicability of the rules of pledge law. A broad interpretation of the term 'financial collateral arrangement' (including fiduciary transfers of financial collateral) is therefore not recommended.

154 See *Tweede Kamer* 2002-2003, 28 874, no. 3, pp. 7-9 and p. 17; and, with some additional clarifying examples, *Tweede Kamer* 2004-2005, 30 138, no. 3, pp. 8-10 and p. 19.

155 See section 3.2.2 above.

The issue is, however, disputed. The Dutch government is of the view that fiduciary transfers should not fall within the scope of Dutch implementing law.¹⁵⁶ Verstijlen, on the contrary, argues that this approach is not consistent with the goal of Article 6 of the Collateral Directive. In his view, fiduciary transfers do fall within the scope of Article 7:55 of the NCC.¹⁵⁷ Van Erp, too, is (implicitly) of the view that fiduciary transfers are covered by the Collateral Directive.¹⁵⁸ In this context, it is interesting to note that under German law a fiduciary transfer of title is covered by the liberal regime of the German law implementing the Collateral Directive.¹⁵⁹

In chapter VI, in regard to the term 'financial collateral arrangement' in the Collateral Directive and Dutch implementing law, a definite choice is made between a narrow interpretation (excluding security interests) and a broad interpretation (including both outright transfers of title and security interests). Before determining which of these interpretations is desirable, it is important to examine the consequences for all parties involved. Chapter IV looks at the 'right of use' envisaged by the Collateral Directive and chapter V further examines the consequences of the Collateral Directive and Dutch implementing law for enforcement upon default.

4. TEMPORARY TRANSFER OF TITLE?

4.1 Introduction

In the Netherlands, a second recharacterisation risk of transfers of financial collateral is sometimes pointed out in connection with Article 3:85 of the NCC. This provision states:

156 See the Additional Explanatory Memorandum (*Nadere Memorie van Antwoord*), *Eerste Kamer*, 2004-2005, 28 874, E, sections 1 and 15.

157 See Verstijlen 2005, p. 73 (footnote 69).

158 See Van Erp 2004 II, pp. 540-542.

159 See the *Diskussionsentwurf des Bundesministeriums der Justitz, Entwurf eines Gesetzes zur Änderung der Insolvenzverordnung, des Bürgerlichen Gesetzbuches und anderer Gesetze*, p. 19. Idem: *Gesetzesentwurf der Bundesregierung, Entwurf eines Gesetzes zur Umsetzung der Richtlinie 2002/47/EG vom 6 Juni 2002 über Finanzsicherheiten und zur Änderung des Hypothekendarlehensgesetzes und anderer Gesetze*, Bundesrat, Drucksache 563/03, 15 August 2003, p. 13; *Gesetzesentwurf der Bundesregierung, Entwurf eines Gesetzes zur Umsetzung der Richtlinie 2002/47/EG vom 6 Juni 2002 über Finanzsicherheiten und zur Änderung des Hypothekendarlehensgesetzes und anderer Gesetze*, Deutscher Bundestag, Drucksache 15/1853, 29 October 2003, p. 12.

1 An obligation intended to transfer property for a specific period is deemed to be an obligation to establish a usufruct upon the property during that stipulated period

2 An obligation intended to transfer property under a suspensive term (*condition precedent*) is deemed to be an obligation to transfer the property immediately and simultaneously establishes a usufruct upon the property in favour of the alienator during the stipulated period¹⁶⁰

A key to understanding Article 3:85 of the NCC is recognising the distinction between conditions (that may or may not be fulfilled) and future events that will, under any circumstances, become reality (such as a future moment in time). Under Dutch law, obligations can be entered into under a condition subsequent (*ontbindende voorwaarde*) and a condition precedent (*opschortende voorwaarde*) if the fulfilment of these conditions is uncertain.¹⁶¹ Article 3:85 of the NCC, however, does not allow a transfer that is limited to a specific term or which takes effect only after a certain term, as it is certain that these terms will irrevocably be realised at a future moment in time. Article 3:85 of the NCC recharacterises an obligation to transfer subject to such terms as an obligation to establish a right of usufruct. In the case of an obligation to transfer property for a specific period of time, such an obligation is characterised as an obligation to establish a right of usufruct for that period.¹⁶² In the case of an obligation intended to transfer property under a suspensive term (*opschortende tijdsbepaling*), this is deemed to be an obligation to transfer that property immediately and to simultaneously establish a right of usufruct in respect of that property in favour of the original owner until the stipulated term.^{163 164}

The Dutch legislator introduced the general provision of Article 3:85 of the NCC in view of the law of inheritance. He did not want to allow subsequent ownership rights that were limited in time for different heirs. In

160 Translation Netherlands Business Legislation Original Dutch text '1 Een verbintenis strekkende tot overdracht van een goed voor een bepaalde tijd, wordt aangemerkt als een verbintenis tot vestiging van een vruchtgebruik op het goed voor de gestelde tijd 2 Een verbintenis strekkende tot overdracht van een goed onder opschortende tijdsbepaling, wordt aangemerkt als een verbintenis tot onmiddellijke overdracht van het goed met gelijktijdige vestiging van een vruchtgebruik van de vervreemder op het goed voor de gestelde tijd '

161 See Articles 6:21-26 of the NCC

162 See Article 3:85(1) of the NCC

163 See Article 3:85(2) of the NCC

164 On the distinction between conditions and terms see, for example, Asser Series 4-I, nos 154 *et seq* and 231 *et seq*, and Snijders / Rank Berenschot 2001, sections 5 6 2 and 5 6 5

this case, the right of usufruct should be applied. In other situations as well, the legislator was of the view that an ownership right that is limited in time should be characterised as a right of usufruct because – as in the case of a right of usufruct – the rights of the different parties involved should be balanced. In addition, the legislator intended to prevent evasion of the rules relating to the right of usufruct.¹⁶⁵

This section examines whether Article 3:85 of the NCC affects transfers of financial collateral under repo or securities lending transactions, and in particular whether the parties to such transactions actually intend a transfer of title without limitation in time or whether they wish to establish a (temporary) right of usufruct. Some attention will also be paid to the approach of the Collateral Directive in this respect.¹⁶⁶

4.2 The non-applicability of Article 3:85 of the NCC

This section investigates how Article 3:85 of the NCC may apply to transactions involving financial collateral. First, it examines instances in which the parties follow the structure of standard agreements, such as the GMRA or the GMSLA. Subsequently, the focus is on two possible scenarios in which the parties deviate from the terms of the standard agreements.

Under the GMRA or GMSLA, financial collateral is transferred to a transferee at the outset of a transaction. The transferee has the right to dispose of the collateral transferred as he pleases, by transferring the collateral to a third party, pledging it, etc. The transferee, however, is contractually obligated to transfer equivalent collateral to the transferor at the end of the transaction – *equivalent collateral*, not necessarily meaning the same assets as the assets transferred at the outset of the transaction as these assets may have been transferred to a third party in the course of the transaction. Is this structure allowed under Article 3:85 of the NCC?

165 On Article 3:85 of the NCC in general, see Meijers' Explanatory Notes, Article 3:2.5, p 187, the Parliamentary History of the NCC, *Boek 3, Vermogensrecht in het algemeen*, Article 3:2.5, pp 185-188 and Article 3:4.2.2a, pp 319-320, Asser Series 3-I, section 224, Kortmann 1992, section 8, Rank-Berenschot 1998, Van Gaalen 2001, sections 203-206, Pitlo / Reehuis, Heisterkamp 2001, sections 128-129

166 On the specific issue of collateralised transactions in light of Article 3:85 of the NCC, see Van Ardenne-Stachiw 1995, p 72 (footnote 108), Verhagen 1997, p 58, Rank-Berenschot 1998, pp 158-159

Article 3:85(1) of the NCC prohibits the transfer of property for a specific period of time. This provision does not apply to transfers of financial collateral under repo and securities lending transactions if – and this will normally be the case – at the end of a transaction, assets different from those provided at the start of the transaction are transferred. Because different, equivalent assets are involved, this cannot, by definition, be a transfer of property for a limited period of time.

Even if it can be established that exactly the same securities are unintentionally transferred at the end of a transaction, Article 3:85(1) of the NCC does not apply. In accordance with the GMRA and the GMSLA, the parties intend an outright transfer of assets at the outset of a transaction, for which Dutch law requires (1) a valid *causa* (*titel*) and (2) an executing act of delivery (3) by an entity that is entitled to dispose of these assets.¹⁶⁷ In line with the standard documentation, they also agree on a transfer of assets (subject to the same requirements) at the end of the transaction. It is generally presumed that Article 3:85 applies only when the obligation to transfer for a specific period of time (the *causa*) is combined with certain legal acts of a proprietary nature, such as two simultaneous acts of delivery or a provision on the basis of which ownership falls back automatically at the end of a transaction.¹⁶⁸ The GMRA and GMSLA, however, do not envisage an automatic fall-back of assets, and, although they do envisage two acts of delivery, these acts are not simultaneous. Whereas an outright transfer of financial collateral, including a first act of delivery, takes place at the outset of a transaction, the second act of delivery occurs only at the end of the transaction. This excludes the applicability of Article 3:85 of the NCC. Moreover, the parties to a GMRA or GMSLA agreement do not intend a transfer that is limited in time. Rather, their intention is that unlimited title to assets transferred falls to the transferee. This intention is reflected clearly by the fact that the transferor accepts the risk of the transferee's insolvency. It is not at all certain that the transferee will be able to fulfil his obligation to transfer equivalent assets at the end of the transaction, which may, in particular, be problematic if he is insolvent. For these reasons, Article 3:85(1) of the NCC is not applicable when the structure of internationally applied standard agreements is followed.

167 See Article 3:84(1) of the NCC.

168 See Rank-Berenschot 1998, pp. 158-159; Van Gaalen 2001, section 205; Pitlo / Reehuis, Heisterkamp 2001, section 128 (particularly the examples at the end of the section).

Article 3:85(2) of the NCC also does not apply to transfers of financial collateral under the GMRA and GMSLA, where the parties intend immediate transfers of financial collateral both at the start and at the end of the transaction as opposed to transfers under a suspensive term, as referred to in Article 3:85(2) of the NCC.

Only when the parties deviate from the structure set out in standard agreements, such as the GMRA and the GMSLA, could there be a problem under Article 3:85 of the NCC. What should the analysis be, for example, if the parties intend a transferee to sit on financial collateral for the entire duration of the transaction (for example, by registering it on a separate account) and to transfer exactly the same collateral on termination? In my view, such a transaction is allowed under Article 3:85 of the NCC because the parties do not intend a transfer that is limited in time. Rather, they intend that the collateral involved falls to the transferee, while the latter is contractually obliged to transfer that collateral at the end of the transaction. Whether the transferee will fulfil this obligation is not certain, and can, for instance, be problematic in the event of the transferee's insolvency.

Nonetheless, Article 3:85(1) does prohibit a transfer for a specific period of time, construed, for example, as two transfers with two simultaneous acts of delivery, or as a transfer at the outset of a transaction combined with a provision on the basis of which the collateral falls back automatically (i.e. without an act of re-delivery) to the original transferor at the end of the transaction. A title to that end runs the risk of being recharacterised as a title to establish a right of usufruct for a limited period of time.¹⁶⁹

4.3 Recovery function

An additional argument against the applicability of Article 3:85 of the NCC to transactions with financial collateral relates to the fact that, in addition to tradeability, such collateral serves a recovery function.¹⁷⁰ The legislator characterises an ownership right that is limited in time as a right of usufruct. The recovery function envisaged by the parties to a financial collateral arrangement is, however, not compatible with a right of usu-

169 Note that in these last two scenarios, in which the parties deviate from the standard documentation, a risk also arises under Article 3:84(3) of the NCC because the tradeability function of the collateral is excluded.

170 See section 2 4 of chapter II and section 3 3 3 of this chapter

fruct. Recourse can be had by a full owner or by someone who has been given a security interest, but not by a usufructuary.

4.4 Income payments and voting rights

Another indicator of whether the parties to a financial collateral arrangement intend to establish a right of usufruct involves the arrangements between the parties in respect of income payments and voting rights. Income payments and voting rights are the typical economic benefits, or 'fruits', of securities. It is therefore interesting to identify who enjoys these fruits. If the transferor of the securities enjoys them, this clearly shows that the parties did not intend to establish a right of usufruct. If, on the other hand, the transferee of securities enjoys income payments and executes voting rights (without any obligation to follow the transferor's voting instructions), this may indicate that a right of usufruct should have been established. Note, however, that the transferee is also entitled to these rights if an outright transfer has taken place.

As was discussed in section 4.5 of chapter II, under the GMRA or GMSLA, an amount equal to *income payments* is, as a rule, transferred by the transferee of securities to the transferor. Because the one who actually enjoys the income payments (which could be considered the fruits of a right of usufruct) is thus the original title-holder of the securities, no recharacterisation as a right of usufruct should take place. But, even if income payments would be for the benefit of the transferee, this would not necessarily mean that a right of usufruct should have been established, because a full owner also has the right to enjoy the fruits of his property.

As shown in section 3.4.3.b ('Economic risks and benefits') above, the approaches of the GMRA and GMSLA in respect of *voting rights* differ. In the case of an equity repo, voting rights are usually carried out in accordance with the instructions of the original title-holder, whereas in a securities lending transaction concerning equity securities, the transferee himself can choose how to execute voting rights. The fruits (i.e. the voting rights) are thus, as a rule, enjoyed either by the original title-holder (repo) or by the transferee of securities (securities lending). Where the original title-holder is entitled to give voting instructions, no recharacterisation as a right of usufruct should take place. But even if the transferee of securities is free to vote as he deems fit, this does not necessarily mean that a right of usufruct should have been established because a full owner also has the right to enjoy the fruits of his property.

4.5 The Collateral Directive

Article 6 of the Collateral Directive is intended to guarantee the enforceability of title transfer financial collateral arrangements in accordance with their terms. Recital 13 of the Collateral Directive also makes it clear that a title transfer of financial collateral should be valid. A title transfer should not be recharacterised as a security interest. Under the Collateral Directive, it must also be considered unacceptable, though, to recharacterise as a right of usufruct a transfer of collateral that has been carried out in line with commonly applied standard agreements. In the Dutch implementing law and the comments thereto, no attention has been paid to the risk of recharacterisation under Article 3:85 of the NCC.

4.6 Conclusion

Article 3:85 of the NCC does not apply to financial collateral that is transferred in line with internationally applied standard documentation for repo and securities lending transactions. Full title to such collateral is transferred at the outset of a transaction. The transferee of financial collateral is entitled to dispose of the transferred securities and is only under a contractual obligation to transfer equivalent securities at the end of the transaction. It is uncertain whether these assets will actually be delivered at that moment. Only if the parties deviate from the terms of the standard agreements and transfer financial collateral for a specific period, would such a transfer not be compatible with Article 3:85 of the NCC.

The fact that financial collateral customarily serves a recovery function is an additional argument that shows that the parties did not intend to establish a right of usufruct. In addition, the analysis of what happens to the 'fruits' of securities (i.e. the income payments and, in the case of equity transactions, the voting rights) confirms that Article 3:85 of the NCC is not applicable to transfers of financial collateral. In a repo transaction, the original title-holder usually receives an amount equivalent to income paid, and can give voting instructions. Likewise, in the case of securities lending transactions, income payments are paid to the original title-holder. Even if voting rights are, in this case, usually executed by the transferee, he does so not as a usufructuary but in his capacity as full owner.

5. CONCLUSION

5.1 Market standard

Under the standard documentation commonly used in Europe and international markets, financial collateral under repo, securities lending and derivatives transactions is provided on the basis of an outright transfer of title.

5.2 Recharacterisation as a security interest?

This chapter has investigated whether a transfer of financial collateral under a repo or securities lending transaction should be considered as a security interest under Dutch civil law. In particular, Article 3:84(3) of the NCC, which prohibits fiduciary transfers of title, leaves room for recharacterisation.

It is submitted that the issue of recharacterisation should be approached by taking a function-based approach. Such an approach does justice to the economic intentions of the parties involved, and leads to fair results. An outright transfer of title has a function different from that of a security interest. In the case of an outright transfer, the parties intend a transfer of all right, title and interest, without limitation. A security interest, on the other hand, such as a right of pledge or a fiduciary transfer of title, has a different, more limited function. It is intended to create an object for recovery purposes. When applying this analysis to transfers of financial collateral, it appears as though such transfers should be structured as outright transfers and not as security interests. Like a security interest, financial collateral serves a recovery function. In addition to recovery, however, in genuine repo or securities lending transactions financial collateral also fulfils a tradeability function that is not compatible with security interests. In accordance with general principles of property law, collateral that is provided on the basis of a security interest only enables the secured party to sell the securities in the event of default. A security interest leads to a fiduciary relationship, which, under normal conditions, prevents the secured party from disposing of the securities. For this reason, there is no recharacterisation risk in genuine repo and securities lending transactions, in which both characteristic functions of financial collateral (recovery and the possibility of entering into further trading) are represented. Moreover, in order to ensure that it fulfils both the recovery

and tradeability functions, financial collateral should be provided on the basis of an outright transfer of title.

If financial collateral is not tradable, it is likely that the parties only envisage a recovery function for the financial collateral and that they should have established a security interest. In such circumstances, there is and should be, a risk of recharacterisation. In the case of a security interest, the core principles apply, thus striking a balance between the interests of the collateral provider, his other creditors and the collateral taker. The parties are in a fiduciary relationship, which should apply particularly as a matter of mandatory law when the collateral provider and the collateral taker are not in equally powerful positions.

For Dutch law, this means that Article 3:84(3) of the NCC is not applicable to transfers of financial collateral in genuine repo and securities lending transactions (structured in accordance with internationally applied standard agreements, such as the GMRA, the GMSLA or the EMA). A transfer of such financial collateral does not envisage giving the transferee a security interest only; rather, it intends to give him full title, so that he can dispose of the encumbered assets. Because financial collateral is transferred outright and can be used to enter into further trading, such a transfer is also allowed under the Dutch Supreme Court's *Sogelease* decision, in which the Court recognised a sale and financial leaseback construction in which assets were transferred and subsequently leased back mainly with the goal of creating an object for recovery. Because an outright transfer of financial collateral is enforceable, the subsidiary right of pledge, which is often vested by market participants in the Netherlands in repo and securities lending transactions, is superfluous. The same is true for Article 2a of the STSA, which eliminates a risk that does not exist.

Article 6 of the Collateral Directive sanctions transfers of financial collateral. It is submitted that Article 6 of the Collateral Directive should be interpreted restrictively and should only apply to outright transfers under genuine repo and securities lending transactions. The Collateral Directive should not apply to traditional security interests, such as fiduciary transfers of title, particularly when the parties are not equally powerful. The interests of collateral provider and collateral taker should be balanced, notably by setting out a prescribed manner of enforcement, by prohibiting appropriation and by stating that any surplus value must be paid to the collateral provider. Complete abolition of these mandatory principles is

not compatible with the fiduciary nature of a security interest because it exclusively favours collateral takers.

5.3 Temporary transfer of title?

An outright transfer of financial collateral under a repo or securities lending transaction, which has been structured in accordance with internationally applied standard agreements such as the GMRA and the GMSLA, runs no risk to be recharacterised as a right of usufruct under Article 3:85 of the NCC. Under the terms of internationally applied standard agreements, financial collateral is not transferred for a specific period of time or under a suspensive term. At the outset of a transaction, a collateral taker obtains full title immediately and not title that is limited in time. The collateral taker is under a contractual obligation only to transfer equivalent collateral at the end of the transaction. Whether or not he is capable of doing so depends on his solvency.

RIGHT OF USE

1. INTRODUCTION

1.1 Introductory remarks

This chapter deals with the right of use of a collateral taker granted on the basis of a security interest as set out in Article 5 of the Collateral Directive. In this study, the term 'right of use' refers to a collateral taker's unlimited right to dispose of a collateral provider's property in his own name and for his own benefit. This chapter focuses on the legal basis upon which such a right of use can be granted. Two different constructions are available. As was shown in chapter III, market participants usually establish a right of use in respect of financial collateral on the basis of a transfer of title. When an outright transfer of title has taken place, a collateral taker, from the point of view of property law, naturally has a right of use based on the full and unlimited entitlement he has acquired (subject, of course, to contractual limitations).¹ The focus of this chapter is, however, on the right of use granted in connection with a security interest. This second construction first appeared in the standard documentation for collateralised transactions in the American financial markets, but has now been introduced in the European Union with the Collateral Directive.² Currently UNIDROIT, too, is considering the introduction of a secured party's general right of disposal in a Preliminary Draft Convention on Substantive Rules regarding Intermediated Securities.³

1 As was shown in section 2 of chapter III, the title transfer method is used in internationally applied standard agreements, such as the Global Master Repurchase Agreement (GMRA) for repos, the Global Master Securities Lending Agreement (GMSLA) for securities lending and, if English law applies, the 2001 Margin Provisions for derivatives (published by the International Swaps and Derivatives Association, or ISDA)

2 For example, the security interest approach is adopted in the ISDA 2001 Margin Provisions in those cases where New York law applies

3 See UNIDROIT 2006, Study LXXVIII – Doc 42, March 2006, Appendix 2, Article 25 The UNIDROIT approach is critically discussed in the Right of Use Report and in Johansson 2005, in particular sections 3 4 and 6 See also section 5 2 6 below

This chapter examines a secured party's general right of disposal from American, English, Dutch and German points of view. The treatment of American and English law is largely historical. American market participants already applied a right of use in connection with a security interest before this concept was introduced in the Collateral Directive. Section 2 discusses how this construction developed under American law, and outlines some of the theoretical problems arising in connection with it. English law is considered in section 3, as the demands placed on the London market, particularly by its American market participants, have been an important factor that has contributed to the introduction of the right of use on the basis of a security interest in European legislation. Finally, section 4 focuses on Dutch law. This section has a more theoretical character and investigates whether the Collateral Directive's right of use is compatible with the system of Dutch property law. In the section on Dutch law comparisons are made with German law.⁴

The use of this construction (a secured party's general right of disposal) has blossomed in the securities markets. This chapter focuses on the origins of a secured party's general right of disposal, and on the question of whether and in what terms this construction can be explained theoretically. The practical consequences of this right for collateral providers and collateral takers are also considered. No particular attention is paid to other issues relating to the securities markets, such as the question of the different forms in which securities may appear (e.g. as physical certificates, or in immobilized or dematerialized form in book-entry systems).⁵ Related, but distinct issues of property law, such as the question of who is the owner of securities that are co-mingled with other securities (and that, as a result, are no longer identifiable), are also not investigated.

In addition to the issue of the legal basis of a right of use, this right can be considered from accounting, regulatory, operational and tax points of view. These issues are mentioned briefly in section 1.4 of this general introduction, but are not dealt with in the analyses of different countries within this chapter.⁶

4 For an analysis of Danish and Italian law, see the Right of Use Report. The analysis of the compatibility of the right of use envisaged in the Collateral Directive with principles of property law in these two countries is to a large extent similar to that set out in the analyses of the countries below.

5 See the EFMLG Report (2003); Goode 1996; Rank 1996 II; Rank / Van Ardenne-Stachiw / Le Rütte 1996 for more on this issue.

6 The tax issue is elaborated upon more extensively by Peters in the Tax Appendix to the Right of Use Report.

Other consequences of the Collateral Directive relating to the provision of collateral on the basis of a security interest, such as, in particular, the liberal enforcement regime envisaged, are discussed in chapter V.

1.2 The title transfer method

In the case of an outright transfer of title, it is obvious that the transferee has a 'right of use', an unlimited right of disposal. He can dispose of the assets he has acquired in any way he deems fit. As was shown in section 2 of chapter III, a number of important standard agreements used internationally for collateralised transactions envisage a title transfer of collateral.⁷ For example, it is current market practice in the United Kingdom, the Netherlands and Germany that financial collateral is provided on the basis of an outright transfer of title (e.g. in the course of repos and securities lending transactions). Similarly, under American law, the title transfer method is frequently applied to provide financial collateral; in the course of repurchase transactions, for example. The title transfer method is now also sanctioned by Article 6 of the Collateral Directive. Outright transfers of title are a perfectly feasible way of structuring collateralised transactions, including a right of use. Its consequences, i.e. the passing of all rights to the collateral taker, are evident to all parties involved.⁸

1.3 The security interest approach

Collateral, in the sense of the Collateral Directive, usually serves two functions. A collateral taker uses the collateral both for recovery purposes and to enter into further trading. Both functions are guaranteed in the case of an outright transfer of title. The transferee has the strongest imaginable 'security interest' and can dispose of the transferred assets as he pleases. However, the European legislator has now enabled a second way of providing collateral. On the basis of Article 5 of the Collateral Directive, a general right to dispose of collateral can be granted on the basis of a security interest.⁹ The security interest guarantees the possibility of recovery, whereas the right of disposal ensures the tradeability of the collateral

7 See, for example, the GMRA, the GMSLA, the 2001 ISDA Margin Provisions (Part 3; English law), and the European Master Agreement for Financial Transactions (EMA).

8 Before the introduction of the Collateral Directive, this was also the only possible way to grant a right of use under Danish, Dutch, German, Italian and English law. See the relevant chapters of the Right of Use Report.

9 For the text of Article 5 of the CD see section 8.4 of chapter II or Appendix 2.

involved.¹⁰ Formerly, the provision of a general right of disposal on the basis of a security interest was impossible under the laws of most, if not all, European countries.¹¹ Article 5 of the Collateral Directive has changed this situation.

1.3.1 Article 5 of the Collateral Directive

On the basis of Article 5 of the Collateral Directive, a right of disposal can be granted to a collateral taker. This means that a collateral taker can be given the right to transfer title to encumbered assets to a third party or to vest a security interest in those assets for the benefit of that third party. If the collateral taker exercises this right, he is, in return, under an obligation to transfer equivalent assets to the collateral provider at the end of a transaction at the very latest. According to Article 5 of the Collateral Directive, once transferred, these equivalent assets are deemed to have been owned by the collateral provider and to have been subject to the collateral taker's security interest from the outset of the transaction. This will be referred to hereafter as 'proprietary substitution'. Of course, if equivalent collateral is provided at the moment that the secured debt is paid off, no proprietary substitution takes place, as the security interest has nothing to attach to anymore. The alternative to the provision of equivalent collateral is that the collateral taker, if the agreement between the parties so provides, can offset the value of the equivalent assets against, or apply it in discharge of, the value of the secured debt.

One of the central issues in the analyses in the sections below is the question of whether, given no event of default, a general right for a secured party to dispose of pledged assets is compatible with key notions of property law. In particular, the following sections address the question of whether a security interest combined with a right of use is compatible with the basic principles of security interests outlined in section 1.3 of chapter III. In line with these principles, a security interest serves a recovery function, and only gives a collateral taker a right of disposal in respect of financial collateral if there is an event of default. Until that moment, the collateral provider retains his ownership interest. Until the moment of default, the collateral taker has a duty of due care in respect of

10 On the two functions of collateral, see also sections 2.4 and 8.2.5 of chapter II, and section 3.3 of chapter III.

11 See, for example, the EFMLG Proposal for an EU Directive on Collateralisation, section 4.1.3; the Opinion of the European Central Bank, section 16; BIS 2001 I, p. 13; the Right of Use Report; and Wood 1995 I, sections 6.41-43.

the encumbered assets. The appropriation or sale of assets is not allowed. The collateral provider also has a right to redeem the encumbered assets by paying off the secured debt. Whether or not a secured party's general right of disposal is in line with these characteristic features of security interests is examined in the following sections.

The most important practical consequence of the right of use is that a collateral provider is likely to be left with a contractual claim against the collateral taker for a considerable period of time, rather than a claim of a proprietary nature relating to the collateral assets. Under the Collateral Directive, a collateral provider is fully entitled to assets at the outset of a transaction ('moment 1'), is left with a contractual claim after a disposal by the collateral taker, possibly during the entire course of the transaction ('moment 2'), and will only become entitled to equivalent assets again at the moment that these are transferred to him by the collateral taker, usually at the end of a transaction ('moment 3').

Some level of comfort is available to the collateral provider if he is able to offset the claim he has against the collateral taker for the delivery of equivalent assets against his obligation towards the collateral taker to pay off the secured debt. Under the Collateral Directive, contractual close-out netting provisions to this end are generally enforceable.¹² However, this is of no avail to the collateral provider if the prices of the collateral he has provided to the collateral taker go up considerably, and in the absence of proper margin arrangements that take changes in market prices into account. In this case, the collateral provider has an unsecured residual exposure in respect of the collateral taker.¹³

1.3.2 The 'horizontal' and 'vertical' relationships

Essentially, a right of use can be envisaged in two relationships – horizontal and vertical. The *horizontal right of use* refers to the situation in which a collateral provider and a collateral taker enter into transactions in commercial markets generally. Traditionally, collateralised transactions involving cash and/or securities, such as repo or securities lending transactions, are entered into between major participants in the financial markets (e.g. commercial and central banks, investment firms, insurance companies, etc.). Member States may, however, also apply the Collateral

12 For some important exceptions, see section 3 of chapter V.

13 Cf. on the issue of an unsecured exposure Benjamin 2000, section 5.64.

Directive to transactions with small and medium-sized enterprises. Whereas the collateral provider can therefore be anything from a small or medium-sized enterprise to a multinational enterprise or bank, the collateral taker will, in practice, usually be a major financial institution.

The *vertical right of use* relates to the special situation in which a client grants a right of use to his bank or custodian¹⁴ in respect of financial collateral that is administered by that the bank or custodian. In this case in particular, the fiduciary nature of the relationship between the parties (a trust or a comparable relationship) should be taken into account, because there is almost per definition an unequal balance of power between the financial institution and its client. The financial institution is under a fiduciary duty to take the interests of clients who have entrusted their assets to its custody into consideration. Clients may well not expect to lose their entitlement to assets when they grant a security interest with a right of use to their bank or custodian, because when they do so they usually remain entitled until an event of default has taken place. In light of this fiduciary relationship, it is undesirable that a client, having pledged assets to his bank or custodian and given it a right of use, thinks he is still entitled to the encumbered assets, while he actually risks losing his right to a third party to whom the financial institution has transferred that right. In this context it should be mentioned that banks and custodians often routinely stipulate a right of pledge on the credit balances of their clients. Can a bank or a custodian also stipulate a right of use on the basis of general conditions, or does such an institution have a special notification obligation in light of the far-reaching consequences of the right of use?¹⁵

In any case, it is clear that the Collateral Directive applies to transactions in the over-the-counter market¹⁶ generally, but is also applicable if a client provides collateral to a bank or custodian.

14 No sharp distinction is made in this study between the terms 'custodian', 'depository' and 'intermediary'. All three terms refer to entities that administer book-entry securities. See the Bank of International Settlements, *A Glossary of Terms Used in Payment and Settlement Systems*, March 2003.

15 The consequences of this probably unintended effect of the Collateral Directive for clients of financial institutions are discussed in-depth in the Right of Use Report in the chapters on the client-custodian relationship under Danish, Dutch and Italian law. For a further discussion of the right of use in the context of the fiduciary relationship between a financial institution and its clients under American and English law, see sections 2 and 3 below.

16 The over-the-counter market is the market outside an officially recognised and regulated exchange.

1.3.3 *A right of use in Europe – Why?*

The idea of introducing a security interest combined with a general right of disposal in the European Collateral Directive has been put forward by the ISDA Collateral Law Reform Group. This group argued that the construction is considered a 'commercial imperative' by financial institutions. If collateral takers are able to make use of pledged assets and to dispose of them in the course of their own business, they can earn money for themselves. This, in turn, allows them to lower the costs of financial services provided to collateral providers. On this basis, the ISDA Collateral Law Reform Group recommended that national rules prohibiting a secured party's general right of disposal, which were arguably in force in all countries of the European Union with the possible exception of Greece, should be put aside. The group formulated the following principle for law reform:

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 clean title to the assets, whether or not they have notice of the original interest of the collateral provider.¹⁷

Morton and Potok, members of both the ISDA Collateral Law Reform Group and of the European Union Forum Group on Collateral (the latter in charge of preparing a draft Collateral Directive), pursued the ISDA ideas in their 'Position Paper on the Taking of Securities as Collateral in the European Union'¹⁸ in December 1999. They present a security interest combined with a right of use as an alternative to an outright transfer of title. In their view, the market becomes more flexible by introducing this new construction, as the collateral taker's right of disposal enhances the liquidity of the markets. These ideas, however, were disputed, in particular because a security interest is, by its nature, a right that is limited to having recourse upon default. As such, it is not compatible with an unlimited right of disposal. But Morton and Potok maintained their position in their January 2000 memorandum 'Securities Collateral: Security Interest Structure and "Right of Use"'.¹⁹ In discussions they had with financial institutions, these institutions indicated that a right of use was 'of critical importance' to them, 'because the ability to use securities constitutes one

17 See the ISDA Report 2000, sections 2, 4.2 and 5. Quotations: section 4.2, p. 6 and section 5, p. 11.

18 See Annex A to the Commission Working Document.

19 See Annex B to the Commission Working Document.

of the key business advantages of the arrangement, which may cease to make economic sense if the ability were to be removed'.²⁰ Whether the ability to 'use' collateral has ever existed in the European Union on the basis of a security interest, as this quotation suggests, is explored in this chapter. In any case, the European legislator has codified the security interest combined with a right of use in Article 5 of the Collateral Directive.

An important argument that has been put forward in favour of a right of use on the basis of a security interest is the positive effect it has on the liquidity of the financial markets.²¹ From a macro-economic point of view, the relative scarcity of financial collateral puts strong pressure on market participants to make optimal use of available resources, including pledged collateral. In 2001, the Committee on the Global Financial System of the Bank for International Settlements noted a potential scarcity of available collateral.²² As one of the possible solutions put forward to deal with increasing scarcity, the Committee suggested a right of use in respect of collateral provided on the basis of a security interest.²³

From a micro-economic point of view, in light of the high level of competition in the financial industry, collateral takers are under strong pressure to make optimal use of assets, including collateral pledged to them, so as to attract cheap credit from third parties.²⁴ It is therefore not surprising that the Collateral Directive's right of use has been proposed and actively supported by the financial industry. The European Financial Market Lawyers Group (EFMLG), consisting of experts working for major financial institutions, has advised that a collateral taker's general right of disposal be introduced.²⁵ This construction has also been actively supported by financial industry associations, such as the ISDA and the FBE.²⁶ As far

20 Quotations are from the Commission Working Document, Annex B, section 3

21 See recital 19 of the CD, and the Opinion of the European Central Bank, section 16

22 See BIS 2001 I and BIS 2001 II

23 See BIS 2001 I, p. 13

24 See Benjamin 2000, section 5 46 *et seq.*, Benjamin / Yates / Montagu 2002, section 4 22, Johnson 1997, pp. 950-951, and section II C

25 See the EFMLG Proposal for an EU Directive on Collateralisation, sections 3 1, 4 1 3 and 6 3

26 See the strongly affirmative ISDA Report 2000. The 2001 ISDA Statement of Position suggests improvements to the text of the provision stated in the draft directive in relation to the right of use. In section 4 of its Preliminary Observations in relation to the Proposal for a Directive on financial collateral arrangements (COM 2001 168 final) of 4 October 2001, the FBE still has some reservations about the right of use: 'As far as the right of use/re-use in the case of pledge is concerned, the European

as collateral providers are concerned, an advantage of a secured party's general right of disposal is that it usually implies lower funding costs for the collateral provider. In exchange for a general right of disposal, the collateral taker can, for example, charge a lower interest rate for funding. The cost to the collateral provider for such cheap funding, however, is that he usually loses his proprietary interest in the collateral provided and risks ending up with a contractual claim against the collateral taker, which, in the event of the latter's insolvency, ranks on a *pari passu* basis only.

Another factor that has probably played a role in the introduction of a security interest combined with a general right of disposal in Europe, is its application in the American market. American participants in the London market wished to be able to apply this construction under English law as well.²⁷

Moreover, a special feature of the securities markets may have played a role in the appearance of a secured party's general right of disposal, particularly in these markets: the perception of ownership in the securities markets is not as clearly defined as in other parts of the economy. For example, a purchaser in the securities markets will often be protected in the case of an unauthorised transfer. In order to guarantee the smooth functioning of the markets, a purchaser has only a limited duty to investigate whether the transferor is indeed entitled to dispose of the assets concerned and is considered to be a bona fide purchaser. For this reason, it is unlikely that the purchaser would have to face a claim by the original title-holder, based on, for instance, tracing or constructive trusteeship. In addition, in practice, tracing investment securities or their proceeds is usually impracticable as there is typically a chain of intermediaries, whereas clearing systems and netting arrangements preclude an identification of a particular transfer at one end to a particular receipt at the other. The result is that an unauthorized disposal of investment securities leads, as a rule, to a mere contractual claim for the original title-holder against the unauthorised transferor, one based, for instance, on a tort for

banking industry has some doubts about its necessity for the market.' However, in a common letter of 3 December 2001 both the ISDA and the FBE support the right of use: 'We also support the right of use/re-use, as this is a common technique which increases liquidity in the financial markets (Article 6 of the draft Directive).'

27 See sections 2 and 3 below for more on this issue.

conversion.²⁸ Yet another factor that contributes to a less clear perception of ownership in securities markets is that investment securities are usually held in fungible pools. The title-holder is generally not too concerned about the specific assets to which his interest attaches (to assets originally in the pool, or their replacement with equivalent assets) as long as there are enough assets available in the pool to fulfil the claims of all title-holders.

However, the importance of the special ownership concept in the securities markets should not be overestimated. It should be taken into account that, for reasons of investor protection, interests in fungible pools of securities usually have a proprietary nature. In the US, for example, the legislator has given a 'security entitlement' distinct proprietary features.²⁹ Likewise, in the European Union, a proprietary claim in securities (e.g. a direct ownership claim or a co-ownership interest in a pool of securities) is the standard. A contractual claim in a pool of securities, which is usually managed by an insolvency-proof entity (another means of investor protection) also occurs, but less frequently.³⁰ Because of these kinds of investor protection, interests in respect of book-entry securities cannot be equated with, for example, a contractual claim for cash against a financial institution. Moreover, irrespective of the nature of the interest in securities (proprietary or contractual), a transfer by a secured party inevitably means that a third party becomes entitled to the encumbered assets and that these assets are no longer available to the provider of security. When the secured party becomes insolvent, the provider of security has no interest in securities anymore, but faces the risk of a mere contractual claim against the secured party that ranks on a *pari passu* basis.

However understandable the wish to be able to use pledged securities may be, it is legitimate and important to explore the theoretical foundations of a security interest combined with a general right of disposal. Are the concepts of a security interest and a general right of disposal compatible? Does this construction with regard to content still have anything in common with a secured transaction or does it resemble an

28 On this policy issue see Benjamin 2000, sections 2.52-65; for a comparable approach under American law, see the UCC (2004 edition), Official Comment to § 8-503 of the UCC, section 3.

29 See Article 8, Part 5 of the UCC, and the related Official Comments.

30 See the EFMLG Report (2003). Consider also, for example, the Dutch SGTA and VABEF structures, which are described in Rank 1996 II; Rank / Van Ardenne-Stachiw / Le Rütte 1996; and by Schim in chapter 3 of the Right of Use Report.

outright transfer? These issues, and the practical consequences of this construction for collateral providers and collateral takers, are further examined in this chapter.

1.4 Other issues

The following sections of this chapter approach the right of use from a civil law point of view. They do not pay in-depth attention to a number of other important issues, which are indicated below.

1.4.1 *Income payments and voting rights*

An owner of securities is entitled to receive income payments and, in the case of equity securities, to execute voting rights, if any, in respect of those securities. It is therefore important for the institutions that issued the securities concerned to determine whether and at what moment in time a security interest combined with a right of use leads to a change in ownership. As soon as ownership passes, the new owner has the right to receive income payments and to vote.

1.4.2 *Accounting, capital adequacy, and registration by custodians*

Accounting issues, the capital adequacy treatment of transactions with a right of use, and the way a right of use should be registered by custodians are not the focus of this chapter. Accountants should decide who will be registered in the books as the owner of securities. Regulators should determine what capital adequacy regime applies when a right of use has been granted. Custodians should show in their records that a general right of disposal has been granted in respect of securities on the basis of a security interest. The legal analysis of the nature of a security interest combined with a right of use (security interest or outright transfer) in the sections below can be used as a reference when determining how this construction should be treated for accounting and capital adequacy purposes, and how it should be registered by custodians.

1.4.3 *Tax*

As noted above, the tax treatment of a right of use should also be considered. Should a transaction involving a right of use for tax purposes be treated as a security interest or an outright transfer of title? The Tax Appendix to the Right of Use Report examines the consequences of the

right of use of the Collateral Directive from a tax point of view. It considers the effect on different taxes. It focuses on consequences for corporate income tax and withholding tax, but some attention is also paid to participation exemptions.

2. RIGHT OF USE UNDER AMERICAN LAW

2.1 Introduction

This section examines a security interest combined with the secured party's unlimited right of disposal under American law. This is the jurisdiction in which this construction was applied before it was introduced in the European Union by way of the Collateral Directive. It is likely that American law has, through the London market, inspired the approach of the Collateral Directive.³¹

The main goal of this section is to give an outline, not an in-depth analysis, of the reasons why this construction has come into fashion in America, and of the theoretical difficulties associated with it.³² As such, this section will be helpful in understanding the issues posed by the Collateral Directive's right of use under the laws of the Member States of the European Union, among them the United Kingdom (see section 3 below), the Netherlands and Germany (see section 4 below).³³

In any case, it is clear that under American law a collateral taker can be given an unlimited right to dispose of assets on the basis of an outright transfer of title. Full title to assets can, for example, be transferred on the basis of a sale agreement. Under American law, repos are, as standard practice, structured as an outright transfer. For example, the TBMA Master Repurchase Agreement envisages an outright transfer of financial collateral under repo transactions.³⁴ In a genuine repo transaction, both

31 See section 3 below for more on this issue

32 See section 1.3.3 ('A right of use in Europe – Why?') for a general overview of factors that may contribute to the appearance of a secured party's general right of disposal

33 For in-depth analyses of 'rehypothecation' or 'repledge' under American law see Johnson 1997, Kettering 1999 I and Kettering 1999 II. See also section 3 of the introduction to the Right of Use Report

34 See Paragraphs 1, 3, 4, 6 and 7 of the TBMA Master Repurchase Agreement

the buyer and the seller have an unlimited right of disposal in respect of the cash and securities transferred.³⁵

Whether a general right of disposal can also be granted on the basis of a security interest is a more intricate issue. Under American law, security interests can, among other things, be vested in investment securities, which are dealt with in Article 8 of the UCC. Securities can be held directly from issuers of the securities, or indirectly through intermediaries. Directly held securities can be in certificated or uncertificated form and are dealt with in the first Parts of Article 8. Securities held indirectly through intermediaries are called 'security entitlements' so as to distinguish them from certificated and uncertificated securities. Security entitlements are dealt with in Part 5 of Article 8 of the UCC.³⁶ Article 9 of the UCC deals with security interests in all kinds of personal property, including securities in certificated or uncertificated form and security entitlements. § 9-207 of the UCC relates to the rights and duties of a secured party having possession or control of collateral. This section serves, if anything, to emphasize the distinction between an outright transfer and a security interest. It sketches the possibilities and rights that a secured party has and also contains implicit limitations to his rights. It is, in particular, under this section that the way in which a security interest and a secured party's general right of disposal relate to each other must be determined.

The secured party's right of repledge, which is set out in § 9-207(c)(3) of the UCC, comes closest to a secured party's general right of disposal. For this reason, the right of repledge is given special attention in this section on American law. There are other instances in which a collateral taker may move collateral. A secured party has the right to assign the secured debt. In this case the collateral generally follows the secured debt. The secured party also has the right to foreclose upon and thus dispose of collateral upon an event of default. These instances, however, do not have much in common with the secured party's right to dispose of encumbered assets separate from the secured debt under 'normal', i.e. non-default circumstances, and are therefore not discussed hereafter.³⁷

35 See also section 3.3.3.d ('Extra illustration: the approach under English and American law') of chapter III.

36 For a good introduction on Article 8 of the UCC, see the Prefatory Note to this provision in UCC (2004 edition), pp. 789-822. See also Rogers 1994 and Rogers 1996.

37 On the different instances in which a secured party can 'dispose' of collateral see Johnson 1997, pp. 972-973; Gilmore 1965, § 42.10.

Section 2.2 below outlines how repledge was used by stockbrokers in their margin lending businesses, and how it was codified in the old and the revised UCC. Section 2.3 considers a secured party's general right of disposal, as applied in the American securities lending and derivatives markets, and which goes even further than the right of repledge. A number of theoretical issues that arise in connection with the constructions of repledge and a secured party's general right of disposal, such as the duty of reasonable care and the equity of redemption, are discussed in section 2.4. Section 2.5 explores whether a security interest combined with a general right of disposal can still be characterised as a security interest, or whether it has more in common with an outright transfer. Section 2.6 contains a conclusion.

2.2 Impairing repledge: the margin lending practice and the UCC

Kettering shows that the margin lending facilities offered by stockbrokers to their clients at the end of the nineteenth century and in the first decades of the twentieth century comprised the traditional setting in which the right of repledge was applied. In the course of 'margin account' or 'margin lending' facilities (1) a stockbroker attracts money from a third party, (2) which money is paid to the stockbroker's client, so that (3) the client can acquire assets, typically securities, in the market. Because the third party wants to be secured, (4) the client grants a right of pledge over his securities to the stockbroker, so that (5) the stockbroker can vest a right of repledge for the benefit of the third party. These are called 'margin' account or lending facilities, because the loan would rarely, if ever, be for 100% of the value of the property. The arrangement would provide for a 'margin' of collateral. If the value of the collateral assets should go down, there would be a 'margin call' to pay down the loan or provide additional collateral. Margin account or lending facilities serve the interests of both the client and the stockbroker. The client is content, because the repledge, in effect, secures a cash flow from a third party that could be used by the client to acquire securities. The stockbroker could earn money on the interest rate to be paid by the client. The margin lending practice, however, did not show a transaction pattern in which a stockbroker's client gave the stockbroker the right to transfer the client's pledged assets

outright to a third party (for example in exchange for a loan with a low interest rate) in the course of the stockbroker's own commercial business.³⁸

In 1953, the right of repledge was codified in the official model text of Article 9-207(2)(e) of the UCC.³⁹ The 1953 provision reads as follows:

Unless otherwise agreed, when collateral is in the secured party's possession [] the secured party may repledge the collateral upon terms which do not impair the debtor's right to redeem it

This provision implies that without default, the situation of margin lending results in a division of the interests in the property between the lender and the borrower. The borrower has his ownership right in the collateral assets, which right is encumbered with the lender's security interest. The secured party's right of repledge or rehypothecation is a limited right of disposal. It allows the secured party to create a further security interest in the collateral he has received from a debtor. This means that the secured party can use the debtor's property in order to secure a debt he has towards a third party. If he does so, the starting point is that the secured party can use only his portion of the value of the collateral, and cannot invade the owner's portion. Article 9-207(2)(e) of the UCC allows the repledge of collateral 'upon terms which do not impair the debtor's right to redeem it'. This means that, in principle, the debt secured by a repledge should not be greater than the original secured debt, and should not mature at a later moment. In the case of such a non-impairing security interest, if the owner redeems his property by paying the debt he has towards the secured party, sufficient value to discharge the debt secured by the right of repledge would be provided. The possibility of deviating from this starting point by way of an agreement was, however, generally accepted. The original owner could – and in practice often did – allow the secured party to enter into an 'impairing' repledge, securing a debt that was many times larger than the original secured debt.⁴⁰

The 1953 model text of Article 9-207(2)(e) of the UCC remained in force until 1999. In 1999 it was revised and renumbered in the course of an

38 See Kettering 1999 I, in particular pp 1112-1115, and Kettering 1999 II, in particular section II. See also Gilmore 1965, § 42 10, Johnson 1997, p 967, the UCC (2004 edition), Official Comment to § 8-504, section 2, and Schwarcz 2001 II, p 291

39 See Kettering 1999 I, pp 1112-1113, Kettering 1999 II, p 92

40 See Kettering 1999 I, pp 1118-1119, Kettering 1999 II, section III

overall revision of Article 9.⁴¹ The new 1999 official text of Article 9-207(c)(3) of the UCC states:

[...] a secured party having possession of collateral or control of collateral [...] may create a security interest in the collateral.

This provision takes a different approach than its predecessor. It allows a repledge, but does not require that the original owner be able to redeem the collateral assets. This means that the revised UCC allows an impairing repledge as a standard. The Official Comments 5 and 6 to § 9-207 of the UCC make clear that a collateral provider who grants a counterparty a right to repledge, may actually face a complete loss of his proprietary interest. Comment 5 states, for example, that 'the debtor's unimpaired right to redeem as against the debtor's original secured party nevertheless may not be enforceable against the new third party'.⁴² Comment 6 makes clear that impairing repledges may occur frequently in the securities markets. If the parties wish to establish a non-impairing right of repledge, they must conclude an explicit agreement to that end.⁴³

The margin lending practice and the provisions of the UCC show that under American law, it is possible to establish a right of repledge, even an impairing one. The right of repledge, however, is arguably something different from a secured party's unlimited right to transfer the collateral outright to a third party, which goes even further. Currently, this latter right is often envisaged in the standard documentation for securities lending and derivatives transactions under American law, and is the topic of section 2.3.

2.3 A secured party's general right of disposal: the securities lending and derivatives markets

Over the past few decades, two types of collateralised transactions have appeared in the American market, namely securities lending transactions and derivatives transactions, which envisage margin transfers that are

41 See Kettering 1999 I, pp. 1111-1113; Kettering 1999 II, p. 175.

42 The comment calls the right to redeem 'unimpaired'. However, this is only true in the relationship between the original owner and the first secured party. From an overall perspective, the right to redeem is indeed impaired, as the original owner's ownership claim may not be enforceable against the second secured party.

43 On this new approach of Article 9-207(c)(3) of the UCC see Kettering 1999 I, section I; Kettering 1999 II, section IV. The Official Comments 5 and 6 can be found in UCC (2004 edition), pp. 990-992.

structured as a security interest combined with the secured party's unlimited right of disposal. This construction goes further than the right of repledge discussed in section 2.2 above, even if it is an impairing repledge, because a right of repledge only gives a right to vest an additional security interest. The structure envisaged in securities lending and derivatives transactions gives the secured party the right to transfer outright title to the collateral assets to a third party.

The TBMA Master Securities Loan Agreement for securities lending transactions envisages an outright transfer of lent securities from lender to borrower, but actually sets out the establishment of a security interest in relation to financial collateral provided by borrower to lender.⁴⁴ In connection with collateral provided on the basis of a security interest, Paragraph 4.2 of the TBMA Master Securities Loan Agreement contains a lender's right to 'retransfer'. Paragraph 25.43 of the agreement explains that 'retransfer' here means in respect of any collateral:

to pledge, repledge, hypothecate, rehypothecate, lend, relend, sell or otherwise transfer such Collateral, or to re-register any such Collateral evidenced by physical certificates in any name other than the Borrower's

This right to retransfer is somewhat limited in scope. It only applies when the lender is a broker-dealer or, as a matter of course, in the case of an event of default by the borrower.⁴⁵

The New York derivatives market provides the most comprehensive example of a secured party's general right of disposal. In this market, a right to 'use' securities means a right for the secured party to dispose of them for his own benefit without any limitation. This right is not limited to default situations or to certain types of market participants. Under Section 2.2(c) of the 2001 ISDA Margin Provisions (New York law) concerning the 'Use of Margin Received' a secured party will, under all circumstances:

notwithstanding Section 9-207 of the New York Uniform Commercial Code, have the right to [] sell, pledge, rehypothecate, assign, invest, use, commingle or otherwise dispose of, or otherwise use in its business, any Margin Received it holds,

⁴⁴ See Sections 1, 2, 3, 4, 6, 7, 9 and 15 of the TBMA Master Securities Loan Agreement
⁴⁵ On securities lending transactions see also Kettering 1999 I, pp 1130-1131; Kettering 1999 II, pp 200-201, the UCC (2004 edition), Article 8, Prefatory Note III C, section 11, pp 807-808

free from any claim or right of any nature whatsoever of the Provider, including any equity or right of redemption by the Provider [...].⁴⁶

It should be noted that the interpretation of the word 'use' in the ISDA Margin Provisions is not in line with what is commonly meant by the word 'use', i.e. the act of employing a thing, without destroying or wasting that thing, and not to transfer that thing or encumber it with a security interest.⁴⁷ The interpretation of the word 'use' in the ISDA Margin Provisions is, in any case, broader than that under Article 9-207(b)(4) of the UCC. This provision makes it possible to agree that a secured party in possession of the collateral may 'use or operate' that collateral. In this provision 'using' means enjoying an asset (e.g. driving a pledged car), but not infringing upon its substance. A collateral taker typically does not have the right to sell the encumbered assets outright, and as such infringe upon the owner's rights, unless there is a default.⁴⁸ In the securities markets, however, a right to 'use' securities does mean a right to dispose of them, i.e. to encumber them with a further security interest, or to transfer them outright to a third party.

More important, however, is that the structure envisaged in the American documentation for securities lending and derivatives transactions goes a step further than the right of repledge. Whereas a right of repledge only gives a secured party the right to create a further security interest (even if this may, in effect, be an impairing one) the documentation mentioned gives a secured party the right to transfer title to collateral assets outright. What is the origin of this new construction?

In the UCC, the only lead to a secured party's general right of disposal can be found in Official Comment 3 to Article 9-314 of the UCC. This Official Comment states:

In a transaction in which a secured party who has control grants a security interest in investment property or sells outright the investment property, by virtue of the

46 This appears in almost the same wording in Paragraph 6(c) of the 1994 New York Annex (ISDA Credit Support Documents). The ISDA Credit Support Documents are the predecessor of the 2001 ISDA Margin Provisions. On the 'right of use' in the derivatives markets see Johnson 1997, in particular section II.A; Kettering 1999 I, pp. 1115-1116; Kettering 1999 II, pp. 53-55.

47 See the definition of 'use' in Black's Law Dictionary.

48 For some examples in case law see UCC Case Digest 1984, pp. 509-513. See also Gilmore 1965, § 42.11. Benjamin 2000, footnote 74, erroneously mentions Article 9-207(4) of the UCC (i.e. an earlier version of current Article 9-207(b)(4) of the UCC) as the basis for a secured party's unlimited right of disposal.

debtor's consent or applicable legal rules, a purchaser from the secured party typically will cut off the debtor's rights in the investment property or be immune from the debtor's claims.⁴⁹

This text mentions a sale of investment property, such as certificated or uncertificated securities or security entitlements, by a secured party who has control. What has inspired this comment? It is my impression that a secured party's unlimited right of disposal, which came into fashion in the securities lending and derivatives markets (as described above), has, to a large extent, been inspired by the right of repledge. Both in the case of a repledge and in the case of an unlimited right of disposal, the original pledgor's proprietary interest can be severely or even completely impaired. The secured party's general right of disposal is, in a sense, an extension of an impairing repledge.

An important factor that has contributed to the appearance of an impairing repledge and a secured party's general right of disposal in the securities markets, is the fungible nature of the collateral involved. Johnson notes that, unlike other types of collateral such as real property, equipment or inventory, collateral in the form of securities is in a very well-suited form to be 'rehypothecated', i.e. disposed of by the original secured party. At the end of a transaction, it is usually no problem for the original secured party to acquire equivalent securities in the market and transfer them to the original owner.⁵⁰ Another factor that has led to the appearance of impairing repledge and a secured party's general right of disposal is the commercial pressure in securities markets. Johnson notes that 'financial institutions participating in the derivatives market aggressively seek (and insist upon) the right to use posted collateral pledged to them'. They do so because it is commercially very attractive to be able to dispose of a counterparty's assets, so as to attract cheap credit, for example. The same, of course, holds true for participants in the securities lending market.^{51 52}

49 See Official Comment 3 to Article 9-314 in UCC (2004 edition), p. 1031. This comment is discussed in Kettering 1999 I, p. 1140 *et seq.* and in Kettering 1999 II, p. 211 *et seq.*

50 See Johnson 1997, p. 967.

51 See Johnson 1997, pp. 950-951. See also Johnson 1997, section II.C.

52 On the factors that have contributed to the appearance of a 'right of use' see also section 1.3.3 ('A right of use in Europe – Why?').

2.4 Remarkable characteristics

2.4.1 Introduction

The secured party's general right of disposal under the TBMA Master Securities Loan Agreement and the ISDA Margin Provisions has a number of remarkable characteristics from a theoretical point of view. In comparison to the right of repledge, the concept of a secured party's unlimited right of disposal deviates more radically from the features of a security interest, which, in principle, gives the secured party a right to have recourse only.

2.4.2 *No equity of redemption*

Article 9-623 of the UCC gives a debtor the right to redeem collateral from a secured party by paying the secured debt and reasonable expenses made by the secured party. The right of redemption gives shape to the debtor's ownership interest. In the case of a repledge, even an impairing repledge, the debtor's right of redemption is arguably still in place, even if it may be unattractive to invoke it from a practical point of view. In the case of a pre-default transfer by the secured party, however, the encumbered asset, or *res*, no longer belongs to the pledgor per definition, but a third party acquirer becomes entitled to it. In this case, the asset to be redeemed has disappeared, which, in effect, makes redemption by the debtor impossible.

For example, the ISDA Margin Provisions, as cited above, state explicitly that a collateral taker can dispose of the collateral provider's assets 'free from any claim or right of any nature whatsoever, [...] including any equity or right of redemption'. It is open to question whether the right of redemption can be bereft of its object just like that. In fact, consenting to a transfer of pledged assets free from the right of redemption boils down to a waiver of that right. Johnson notes that under the 1994 version of Article 9 of the UCC the right of redemption could not be waived.⁵³ Likewise, under current Articles 9-602(11) and 9-624 of the UCC, the right of redemption may not be waived, unless after default. Kettering correctly argues that a security interest without a debtor's right of redemption, as

53 See Articles 9-501(3) and 9-506 of the 1994 version of the UCC, available in UCC (2004 edition), pp. 1860-1862 and p. 1867, and discussed in Johnson 1997, p. 975 and pp. 978-979.

it occurs in securities lending and derivatives transactions, is an anomaly. In his view, this anomaly is a consequence of the margin lending practice that allowed for an impairing repledge and rendered the right to redeem a fiction, if not theoretically, than in any case from a practical point of view.⁵⁴

2.4.3 *Duty of reasonable care*

Article 9-207(a) of the UCC imposes a duty upon a secured party to use reasonable care in the custody and preservation of collateral in the secured party's possession. Johnson notes that this duty precludes the secured party from disposing of the posted collateral without the express authorization of the pledgor.⁵⁵ It is, however, appropriate to take one step further and ask whether the duty of reasonable care is at all compatible with a secured party's general right of disposal. How can a secured party still exercise reasonable care in custody and preservation of collateral, if, for instance, the collateral has been transferred outright and belongs to a third party? Kettering is right when he argues that a secured party's general right of disposal and the duty of reasonable care are, in principle, not compatible. Nonetheless, he refers to the accumulated weight of the early margin lending practice, which featured an impairing right of repledge, in which the duty of reasonable care was also, in fact, bereft of meaning.⁵⁶

2.4.4 *Residual rights?*

It is evident that the rights of a collateral provider have no substance from the moment a collateral taker disposes of the collateral assets. The equity of redemption no longer has any object to which it attaches, and the duty of reasonable care can no longer be exercised. The proprietary claim of the collateral provider is replaced by a contractual claim for the transfer of equivalent assets. But what is the situation up to the moment of disposal? Is it possible to qualify the relationship between the parties up to that moment as a secured transaction?

An argument in favour of a continuing security interest is that the collateral provider retains his ownership interest until the moment the right of

54 See Kettering 1999 I, pp. 1153-1155; Kettering 1999 II, pp. 226-229.

55 See Johnson 1997, p. 972.

56 See Kettering 1999 I, footnote 7 and, in particular, p. 1154; Kettering 1999 II, section IV.A.2 and, in particular, p. 227.

disposal is exercised. Moreover, the collateral provider can reclaim the collateral assets by paying off what is due to the collateral taker. It should, however, be noted that these are 'weak' rights. Not only are they subject to the owner's own default on the secured obligation, as is usually the case in a secured transaction, but also to the collateral taker's general right of disposal, which can be exercised at any moment and poses a permanent threat to the owner's rights (rather like the sword hanging above the head of Damocles).

Note that the same analysis is valid in the event of the secured party's insolvency. It is obvious that in this event the secured party's security interest does not end. Arguably, the same is true for the right of use. Even if the secured party himself may no longer be entitled to exercise the right of use (because he is insolvent) the insolvency administrator is entitled to do so. In principle, this power does not end with the insolvency of the secured party. After all, the secured party will usually only have been able to stipulate a right of use in exchange for a low interest rate, for instance. In other words, he has 'paid' for this right. If the insolvency administrator actually exercises the right of use, the security provider is left with a contractual claim for the transfer of equivalent assets. In practice, this scenario will not occur that often, as the secured party's insolvency will usually trigger contractual close-out netting provisions.⁵⁷

2.4.5 No interest in the proceeds

The securities lending and derivatives documentation does not envisage any interest for the collateral provider in the proceeds of a disposal by a collateral taker (a kind of proprietary substitution). If sales occur, rights in the proceeds are not determined by the pre-sale rights in the collateral, but the collateral taker is exclusively entitled to them. For example, the ISDA Margin Provisions (New York law) do not envisage any right of a proprietary nature for the collateral provider whatsoever. Section 2.2(c) of these provisions gives a secured party the right to dispose of collateral 'free from any claim or right of any nature whatsoever of the Provider, including any equity or right of redemption by the Provider [...]'. The collateral provider has a contractual claim for the transfer of equivalent assets only.

⁵⁷ On close-out netting see section 4.7 of chapter II and section 3 of chapter V.

Of course, the parties can agree to a trust on the proceeds, for instance, in order to protect the position of the original owner. However, this is not the approach of the standard documentation, which does not envisage a trust on the proceeds or any other proprietary interest in the proceeds for the collateral provider. There is also a practical reason why establishing a trust on proceeds may prove difficult. As was already noted in section 1.3.3 ('A right of use in Europe – Why?') above, in practice, tracing investment securities and their proceeds is often impracticable as there is typically a chain of intermediaries, whereas clearing systems and netting arrangements preclude an identification of a particular transfer at one end to a particular receipt of assets at the other.⁵⁸

2.5 The characterisation issue

Eventually, the question arises as to whether a security interest combined with a secured party's general right of disposal can still be characterised as a security interest, or if it is actually an outright transfer.

In 1965 Grant Gilmore argued that a transfer of collateral by a pledgee to a third party should be characterised as a conversion, even if the pledgee had been given the power to do so in the pledge agreement. He stated:

Needless to say, the common law has always stigmatized such a transfer of a pledgor's property as a conversion. It may safely be assumed that the conversion would be a conversion still even if the pledge agreement authorized the pledgee to sell the property (without assigning the debt) whenever he felt like it. The Code says nothing about such unauthorized sales by secured parties in §9-207 or in any other section. Such a sale would seem clearly to be a violation of the secured party's inescapable duty to use reasonable care in custody and preservation of the collateral so that we may conclude that the Code secured party has no more right to sell the collateral without assigning the debt than a common law pledge did.⁵⁹

Like Gilmore, Kettering wonders whether a security interest combined with a general right of disposal as an outright transfer can still be characterised as a security interest. Kettering argues that 'the most natural characterisation of the relationship after the pledged securities are sold is not as a secured transaction, but rather that the two parties are mutual creditors'.⁶⁰ In his view, the statement in Official Comment to Article 9-314

58 See section 3.4.5 and section 4.7 below for rules of 'proprietary substitution' under English and Dutch law respectively.

59 See Gilmore 1965, § 42.10, p. 1156. This passage is discussed in Kettering 1999 I, p. 1127 *et seq.* and Kettering 1999 II, p. 195 *et seq.*

60 See Kettering 1999 II, p. 197.

of the UCC (quoted in section 2.3 above), that a secured party may sell collateral to a third party, which presumes that the relationship between the parties should still be characterised as a secured transaction, leads to 'conceptual acrobatics' and 'irreducible anomalies'.⁶¹

In my view, a secured party's general right of disposal as envisaged in the TBMA Master Securities Loan Agreement and the ISDA Margin Provisions is essentially an outright transfer. Until the moment of disposal, the collateral provider arguably still has a number of rights, notably the ownership right and the right to redeem. But these rights are weaker than the rights that a provider of security normally has. Not only are they subject to the collateral provider's default, but also to the collateral taker's general right of disposal, which may be exercised at any moment in time. After the moment of such a disposal, the original owner's proprietary interest is replaced by a contractual claim for the transfer of equivalent assets. He cannot exercise his right of redemption, and the collateral taker cannot fulfil his duty of due care. Moreover, the collateral provider has no interest in the proceeds from such disposals. The collateral taker has so many rights and the collateral provider so few, that, with regard to content, the collateral taker should be treated as the owner of the collateral. This approach coincides with that taken in the American repo markets (see section 2.1 above), in which financial collateral is customarily provided on the basis of the outright transfer method.

2.6 Conclusion

The belief that a security interest can be combined with an unlimited right of disposal under American law has been a factor that has contributed to the envisaging of such a construction in the Collateral Directive (see in particular section 3 below). For nearly two decades this construction has indeed been applied in the American securities lending and derivatives markets. However, this construction has dubious theoretical underpinnings. It is closely related to and has probably been inspired by the (impairing) right of repledge, which was originally applied in the American margin lending business and was later codified in the UCC. A secured party's general right of disposal, however, goes one step further than an impairing repledge. Until the right of disposal is exercised, the ownership and redemption rights of the provider of security are only a weak reflec-

61 Quotations Kettering 1999 II, p 221 and p 235 For an in-depth analysis, see Kettering 1999 I, in particular section II, Kettering 1999 II, in particular section IV B

tion of the rights that a provider of security ordinarily has. Not only are they subject to the security provider's own default, but also to the collateral taker's right of disposal. After exercise of the right of disposal by the collateral taker, the rights of the original owner are impaired definitely. The original owner can no longer redeem the encumbered assets, to which a third party acquirer is now fully entitled. Neither can the secured party fulfil his duty of due care any longer. Moreover, the original owner has no interest in the proceeds from the disposal by the secured party, as he is left with a contractual claim only. Whereas the construction of a repurchase could, with some effort, still be reconciled with the characteristics of a security interest, this does not hold true for a secured party's general right of disposal. With regard to content, this structure has so much in common with an outright transfer, that the correct approach seems to suggest that it be treated as such, for tax, capital adequacy and accounting purposes, for example.

3. RIGHT OF USE UNDER ENGLISH LAW

3.1 Introduction

This section demonstrates that it is not necessarily the case in common law jurisdictions that a collateral taker can be granted a general right of disposal (i.e. the right to vest a security interest in respect of a collateral asset or to transfer it outright) on the basis of a security interest. In the American securities lending and derivatives markets, a secured party is regularly granted a general right of disposal.⁶² However, granting a general right of disposal to a secured party is traditionally alien to English law. It is the author's impression that the right of use in the Collateral Directive has been inspired by American law and stems to a large extent from pressure by participants in the London financial market.⁶³ The following quotation is illustrative:

62 Note, however, that it is likely that a security interest combined with a general right of disposal should, under American law and with regard to content, be characterised as an outright transfer. See section 2 above.

63 See e.g. Benjamin 2000, p. 111 (footnote 74), McCormack 2003, section on 'EC Financial Collateral Directive' and Conclusion, and the discussion papers by Morton and Potok in the Commission Working Document, Annex A (in particular section A 2 (c)), and Annex B (in particular section 3). See also section 1.3.3 above ('A right of use in Europe – Why?')

The documentation for prime brokerage is not standardised. In many cases, the transaction between hedge fund client and broker is structured as a security interest with a right of use, notwithstanding the legal complexities associated with this. I believe this is largely because prime brokers have modelled their documentation on US documentation, where Article 9 of the UCC permits a right of use.⁶⁴

This section provides an overview of the main issues relating to a secured party's general right of disposal under English law. Section 3.2 is of a practical nature, and focuses on segments of the financial markets in which parties who establish a security interest are inclined to give the collateral taker an unlimited right of disposal, such as in the context of prime brokerage, or in the case of the client – custodian relationship. Section 3.3 examines whether the standard documentation governed by English law for repurchase, securities lending and derivatives arrangements, envisages a secured party's general right of disposal. Section 3.4 examines whether a security interest is compatible with a general right of disposal under English law from a theoretical point of view. Section 3.5 investigates the validity of a number of arguments that have been put forward in favour of the introduction of a security interest combined with a general right of disposal. Section 3.6 considers the Financial Collateral Arrangements (No. 2) Regulations 2003, which implement the Collateral Directive in the United Kingdom. Section 3.7 contains a conclusion.^{65 66}

3.2 Prime brokerage and custody

3.2.1 Introduction

Benjamin has pointed out the main sectors of the economy in which a secured party's general right of disposal is sometimes considered. Like in the US, this construction is applied in the securities industry, in particular because of the 'tremendous' commercial pressure on financial institu-

64 Source: an e-mail to the author from Dr J. Benjamin, London School of Economics (12 August 2003). See also section 3.2.2 on prime brokerage below.

65 Because a secured party traditionally is not granted a general right of disposal under English law, the literature on this subject is scarce. The most comprehensive review of the issue can be found in Benjamin 2000, chapter 5 C. For further, but more fragmentary treatments of the subject, see the references in the footnotes below.

66 Benjamin 2000, chapter 5 C, uses the term 'rehypothecation' to indicate a secured party's general right of disposal. Because 'rehypothecation' or 'repledge' may be understood to relate to a right to vest a security interest only, these terms are not used in this section to refer to a general right of disposal.

tions.⁶⁷ In the United Kingdom, the issue plays a particularly important role in the context of prime brokerage arrangements, and on a more general level in the client – custodian relationship. This section investigates under what circumstances a prime broker and a custodian can dispose of their clients' assets.⁶⁸

3.2.2 *Prime brokerage*

Prime brokerage is a bundle of services offered by financial institutions to their hedge fund clients. Often a prime broker provides the hedge fund client with considerable amounts of funding. In exchange, the prime broker usually has a security interest in the hedge fund's security portfolio. The prime broker customarily stipulates the right to transfer the encumbered securities out of its client's securities account into its own account, subject to an obligation to deliver equivalent assets to the client. This enables the prime broker to dispose of its client's assets. Essentially, this arrangement is an application of the construction of a security interest combined with the secured party's general right of disposal. It is believed that this structure has come into being because prime brokers have modelled their documentation on US documentation.⁶⁹

Under English law, however, this construction raises concerns. The right of disposal not only runs the risk of being declared invalid by a judge, but the construction as a whole also risks being characterised as an outright transfer. This is mainly because of the circumstance that a conversion at the mere discretion of the secured party is equivalent to an option to purchase, which the courts traditionally consider an offence against the principle that there can be no clog on the secured party's right to redeem the encumbered property.⁷⁰ By the same token, even if the prime brokerage documentation itself envisages a conversion of the security interest into an outright transfer arrangement at the moment of actual use (which happens regularly in practice) the construction itself is vulnerable. The above shows that a security interest cannot be combined that easily with

67 See Benjamin 2000, section 5.46. See also Benjamin / Yates / Montagu 2002, section 4.22.

68 See in particular Benjamin 2000, chapter 5.C and chapter 10.B.

69 See the quotation in section 3.1 above.

70 For further information on the equity of redemption, see section 3.4.2 below.

a general right of disposal. Such a right can be declared invalid, or the structure as a whole can be recharacterised as an outright transfer.⁷¹

3.2.3 *The client – custodian relationship*

The issue of a secured party's general right of disposal also plays a role on a more general level in the relationship between a custodian and his clients. Can a custodian dispose of his clients' assets on the basis of a security interest?

a. Starting point: the beneficiary's interest

In current practice, there is often no direct link between an issuer of securities and investors. Securities are commonly held through a chain of custodians who act as intermediaries.⁷² Benjamin and Austen-Peters have asserted that in this indirect holding system the relationship between a custodian and his client should, under English law, be characterised as a trust. A trust can relate to intangible goods, such as indirectly held securities. In such a trust, the custodian is the trustee and therefore the legal owner of the assets. The client is the beneficiary of the trust, and has a beneficial interest in the trust property.⁷³

In principle, the custodian does not have the power to dispose of his clients' assets in the course of his own business because he acts in the capacity of a trustee. It would be incompatible with his fiduciary duty towards the client/beneficiary for a custodian to dispose of his clients' assets and to pocket the profits. Any dispositions should be for the benefit of the clients.⁷⁴

71 See Benjamin 2000, sections 10.49-10.59, and p. 117 (footnote 101), Benjamin / Yates / Montagu 2002, sections 4.8, 4.33-34

72 Because the so-called indirect holding system is predominant in practice, direct holdings are not discussed here. On this issue, see Austen-Peters 2000, sections 2.20-24.

73 See Benjamin 2000, chapter 2, Austen-Peters 2000, in particular sections 2.25-2.32

74 Of course, the custodian-trustee may ask for a reasonable fee for his services. See Martin 2001, pp. 601-606

b. Basis for a right of disposal: outright transfer, not a security interest

Of course, a client is free to transfer his beneficial interest in book-entry securities to his custodian outright.⁷⁵ In this case all rights (i.e. legal interest and beneficial interest) lie with the custodian who can then dispose of them freely. Under English law, however, a client cannot grant a custodian a general right of disposal on the basis of a security interest. For reasons to be discussed in section 3.4 below, such a contractual right may well be declared invalid, or alternatively, the structure runs the risk of being characterised as an outright transfer. For this reason, custodians who stipulate a right of disposal as a matter of course, often do so on the basis of securities lending agreements. Securities lending agreements are, under English law, customarily structured as an outright transfer.⁷⁶ An outright transfer, as a matter of fact, entails a general right of disposal.

3.3 The approach of the standard documentation

Under standard agreements used by English market participants, the provision of financial collateral in repo and securities lending transactions takes place on the basis of an outright transfer. This is true for the GMRA and the GMSLA, but also for the earlier 1995 Overseas Securities Lender's Agreement.⁷⁷ Moreover, the 2001 ISDA Margin Provisions only envisage an outright transfer of collateral under English law. The 1995 Deed subject to English law (one of the Credit Support Documents preceding the 2001 Margin Provisions) did make it possible to vest a security interest. However, no right of use could be established in connection with such a security interest.⁷⁸ The structure of the standard documentation applied in the English financial markets therefore confirms the impression that a security interest and a right of use are mutually exclusive concepts.

3.4 Theoretical considerations

3.4.1 Introduction

Turing and Lester have noted that:

75 As the trustee is the legal owner, the only thing a beneficiary/investor can dispose of is his equitable interest.

76 See also section 3.3 below.

77 See also section 2 of chapter III.

78 See Paragraph 6(d) of the 1995 English Deed.

Re-use has been a particular problem in the United Kingdom, since there have been legal bars which arguably preclude re-use, even where expressly agreed to by the customer.⁷⁹

What exactly are the legal bars that preclude a secured party's general right of disposal? Benjamin and McCormack mention three equitable rules that are possibly not compatible with a secured party's general right of disposal. These are: the rule 'once a mortgage, always a mortgage', the related rule on clogs on the equity of redemption, and the rule against collateral benefits.⁸⁰ The relationship between these three rules and a secured party's general right of disposal is outlined below. Whether the collateral provider has any proprietary rights left in the event the secured party has a general right of disposal is also considered. Moreover, attention is paid to the question of whether a collateral provider has an interest in the proceeds upon the sale of collateral assets, or in equivalent assets to which the collateral taker is or will be entitled.

3.4.2 *'Once a mortgage, always a mortgage', and the equity of redemption*

Benjamin shows that the rule 'once a mortgage, always a mortgage' and the collateral provider's equity of redemption are closely interrelated rules that have long since been firmly upheld under English law. The equity of redemption means that a collateral provider has the right to the return of the encumbered asset upon discharge of the secured obligation. As a general rule, the collateral provider cannot waive the equity of redemption by contract. The equity of redemption is considered a characteristic feature of a security interest. Waiving the equity of redemption would therefore also be incompatible with the rule 'once a mortgage, always a mortgage'. Granting a secured party a general right of disposal cannot be reconciled with these two rules.⁸¹

Goode takes a more liberal view. According to Goode 'it is open to the parties to agree that the mortgagee is to have a power of sale even without default, and such an agreement is not void as impairing the equity of redemption'.⁸² Essentially, Goode makes a distinction between default and non-default situations. He proposes that the equity of redemption does

79 See Turing / Lester 2005, p. 70.

80 See Benjamin 2000, in particular sections 5.50-53; McCormack 2003, section on 'EC Financial Collateral Directive'.

81 See Benjamin 2000, sections 5.53-54. See also Benjamin / Yates / Montagu 2002, section 4.22; McCormack 2003, section on 'EC Financial Collateral Directive'.

82 See Goode 2003, section 6-30.

have a value in default situations, but may not be that much of an issue in non-default situations in which a collateral taker wishes to dispose of the encumbered property involved.

In support of his view Goode mentions two cases. The first case (*The Maule*, [1997] 1 W.L.R. 528) relates to a mortgagee's power to dispose of an encumbered ship upon a non-monetary event of default. Contrary to judges' decisions earlier in the procedure, it was held on appeal that such a disposal is possible. The case, however, does not support the view that the equity of redemption is not applicable in a non-default situation. First, the security provider did default in this case, and second, it was held that the secured party's right to dispose is subject to the equity of redemption. *The Maule* only shows that the option to redeem encumbered assets need not be given in the security agreement itself. It is sufficient that the creditor, in fact, gives the debtor reasonable notice of an intended sale and an opportunity to redeem. In the second case mentioned by Goode (*Langton v. Waite*, (1868) LR 6 Eq 165) a stockbroker was held to have no implied right to dispose of collateral securities, and was obliged to account for the profits of an unlawful disposal to the collateral giver. In an aside, the judge remarked that in his view, a collateral taker's right of disposal can be agreed upon in a contract, but in this case there was no such agreement, so this consideration has limited value.⁸³ The cases mentioned are not compatible with the majority of the cases mentioned in Benjamin 2000, and with regard to content, hardly support Goode's argument that the equity of redemption is not applicable in a non-default situation.

There are two more substantial arguments that can be advanced against Goode's proposition that a distinction should be made between default and non-default situations. The first is that customarily, security interests have a function in default situations only. A security interest gives the collateral taker the option to have recourse if the collateral provider does not fulfil his obligations. Typically, a security interest does not serve a function in non-default situations. Goode's approach, however, implicitly extends the scope of the functions that a security interest may fulfil. In his view, a security interest not only serves its traditional recovery function in default, but can also be applied to make collateral assets tradable. In this respect, he signals a new approach to the issue. A second objection to Goode's proposition is that a disposal by the collateral taker usually results in a loss of proprietary interest on the side of the collateral

83 See also Benjamin 2000, chapter 5, footnote 100.

provider. He is left with a contractual claim, unless a form of proprietary substitution takes place (on this issue see subsection 3.4.5 below). As opposed to an ownership interest, a collateral provider's mere contractual claim is hardly compatible with the concept of a security interest. In light of the above, the relaxation of the equity of redemption as proposed by Goode does not seem tenable.

3.4.3 *No collateral benefits*

Another equitable rule mentioned by Benjamin as a possible obstacle to a secured party's general right of disposal, prohibits collateral benefits. It basically means that a collateral taker should not reserve to himself any collateral advantage outside the collateral agreement, in addition to payment of interest, cost and principle. Currently, this rule is only applied in the case of unfair and unconscionable provisions in an agreement. Benjamin therefore argues that the rule has little meaning in the case of transactions involving financial collateral, particularly if the collateral giver and taker are both financial institutions. In the event of a lopsided power relationship, however, as might exist between a custodian and his non-financial client, the rule on collateral benefits could, arguably, be invoked as an argument against the construction of a secured party's general right of disposal.⁸⁴

3.4.4 *Residual rights?*

Arguably, the original owner still has some rights until the moment that the secured party makes use of his general right of disposal. He is still the formal owner of the collateral assets, and can redeem them by paying off the secured debt. These rights are nevertheless weaker than those of an 'ordinary' provider of security. Normally, an ownership interest that is encumbered with a security interest is lost only in the case of a default by the security provider. When the secured party has a general right of disposal, however, the ownership and redemption rights of the security provider are also subject to this right of disposal, which may be exercised at any moment in time, and which wipes out the security provider's proprietary rights entirely.⁸⁵

84 See Benjamin 2000, sections 5.55-56. See also McCormack 2003, section on 'EC Financial Collateral Directive'.

85 On the issue of residual rights, see also sections 2.4.4 and 4.6.4.

3.4.5 *An interest in proceeds or equivalent assets?*

In favour of a secured party's general right of disposal, Goode has argued that the equity of redemption 'simply attaches to the proceeds of the sale'.⁸⁶ One could question whether it is compatible with the nature of a security interest that a collateral provider may, upon a disposal by the collateral taker, be faced with entirely different assets upon payment of the secured debt. In any case, Goode's rule provides comfort to the collateral provider who, albeit not in the original assets, has an interest in the proceeds of the sale of those assets.

Benjamin is somewhat more reserved. Like Goode, she envisages an interest of the collateral provider after a disposal by the collateral taker, but not in the proceeds of the sale. She proposes an interest in equivalent assets to which the collateral taker is or will be entitled. This rule is more in line with what a security interest actually is, because upon redemption the collateral provider will be the owner, if not of exactly the same assets, than, in any case, of assets equivalent to the ones he originally transferred. Benjamin's rule, however, is also less advantageous to the collateral provider than that of Goode, because it is not necessarily the case that the collateral taker is actually entitled to equivalent assets. According to Benjamin, if there are no equivalent assets in place, the collateral provider is left with a contractual claim.⁸⁷

The Collateral Directive goes even further. Article 5(3) of the directive does not envisage an immediate interest for the collateral provider in the proceeds of a sale, or in equivalent assets to which the collateral taker becomes entitled. It only provides for an interest of the collateral provider in equivalent assets after these have been transferred to him by the collateral taker. This means that he merely has a contractual claim against the collateral taker for the delivery of equivalent assets from the moment the collateral taker exercises his right of disposal, and until the moment the collateral taker actually transfers equivalent assets. This is not an enviable position, because it implies that during this time frame the collateral provider runs an insolvency risk in respect of the collateral taker. In any case, it is clear that the Collateral Directive leaves hardly any of the protection envisaged by Goode.

⁸⁶ See Goode 2003, section 6-30.

⁸⁷ See Benjamin 2000, section 5.64.

Under English law, the parties could agree to a trust on the proceeds of an authorised disposition by the collateral taker in order to overcome the negative consequences of the Collateral Directive. Such a trust does not arise automatically, but would depend on the agreement of the parties. However, as in the American markets, it is not likely that the parties to a collateral arrangement will, in practice, envisage a trust on proceeds. This is because a trust on proceeds is not in the interest of the collateral taker. Furthermore, as was already indicated in section 1.3.3, tracing the proceeds of investment securities is usually difficult, if not impossible in practice, because typically there is a chain of intermediaries. Moreover, clearing systems and netting arrangements preclude an identification of a particular transfer at one end to a particular receipt at the other.⁸⁸

3.4.6 *Concluding remarks*

McCormack and Benjamin mention a few cases in which a secured party's general right of disposal in respect of securities was sanctioned.⁸⁹ McCormack, however, notes that it is not that easy to fit the concept of a secured party's general right of disposal into English law, and pleads for a clarification of the underpinnings of the concept by the legislator in the course of the implementation of the Collateral Directive in the United Kingdom.⁹⁰ Benjamin's general conclusion is that a secured party's general right of disposal is not compatible with the equitable rules outlined above.⁹¹ In my view, this is the correct approach. Wood states:

It seems to be the case in most developed legal systems that the beneficiary loses his proprietary in rem interest if the custodian can use the securities as his own, e.g. by borrowing them or selling them, even if the custodian must substitute equivalent securities or replace them with cash. The right of the custodian to treat the securities as his own is inconsistent with the investor's ownership.⁹²

From a practical point of view, it is understandable that a secured party's general right of disposal is considered in the securities markets. In this market in particular, there is strong commercial pressure to make optimal

88 See section 2.4.5 above and section 4.7 below for substitution rules under American and Dutch law respectively

89 See Benjamin 2000, section 5.63. See also McCormack 2003, section on 'EC Financial Collateral Directive'

90 See McCormack 2003, section on 'EC Financial Collateral Directive' and Conclusion. A clarification by the legislator has not, however, been provided, see section 3.6 below

91 See Benjamin 2000, section 5.66

92 Quotation: Wood 1995 I, section 6.41. See also sections 6.42-43

use of assets. Moreover, tradable securities can, by their nature, easily be replaced by equivalent assets.⁹³ A secured party's general right of disposal, however, is not compatible with the rule 'once a mortgage, always a mortgage', the equity of redemption or the rule prohibiting collateral benefits. This is particularly true in the case of a lopsided power relationship.⁹⁴ Until the moment of the actual disposition, the collateral provider arguably still has his ownership interest and the right to redeem, but these rights have a weak character, because they are not only subject to the collateral provider's own default, but also to the collateral taker's general right of disposal. Moreover, the possibility that, upon disposal, the collateral taker is left with a contractual claim only is not compatible with the essence of a security interest. The collateral provider loses all his proprietary rights and, under the Collateral Directive, does not have a right to the proceeds of a disposal by the collateral taker. In my view, the construction of a security interest combined with a general right of disposal has so much in common with an outright transfer, that it should be characterised as such.

3.5 Additional arguments for change?

A number of factors that have contributed to the introduction of a secured party's general right of disposal have already been mentioned in section 1.3.3 ('A right of use in Europe – Why?'). Benjamin advances two additional arguments in favour of this construction. Neither of these arguments seems convincing and they are refuted below.

1. First, Benjamin argues that, whereas the outright transfer method and insolvency set-off are generally enforceable under English law, this may not be the case in foreign jurisdictions. In the case of cross-border transactions, the outright transfer method may therefore not be an attractive option. The alternative proposed by Benjamin to reach the same economic result is a security interest combined with a right of use.⁹⁵

The argument concerning outright transfer and set-off is, however, no longer valid for transactions covered by the law of a Member State of the European Union after the implementation of the Collateral Directive. The

93 For comparable considerations under American law, see the last paragraph of section 2.3 above. See also section 1.3.3 ('A right of use in Europe – Why?').

94 See also Benjamin 2000, section 5.62.

95 See Benjamin 2000, section 5.67. See also Benjamin / Yates / Montagu 2002, section 4.22.

Collateral Directive recognises the outright transfer method and contractual close-out netting arrangements in the case of collateralised transactions.⁹⁶ In the United States, an outright transfer is a perfectly viable way to provide collateral, whereas a secured party's general right of disposal has shaky foundations from a theoretical point of view.⁹⁷ Moreover, it seems unlikely that the construction of a secured party's general right of disposal is currently applied in many other jurisdictions, and can offer the legal comfort for which Benjamin argues.

2. Benjamin's second argument in favour of a right of use is based on the legal characterisation of different types of securities. A distinction should be made between non-dematerialised securities and dematerialised securities that are registered by intermediaries. As far as non-dematerialised securities are concerned, a *legal* interest can be delivered. If a third party C obtains a legal interest in these securities from a collateral taker B, this interest is protected against the original collateral provider A's equity of redemption, if C is acting in good faith. C's legal interest prevails over A's equitable interest. However, if C acquires from collateral taker B an interest in securities that are held by an intermediary, this interest is not legal but *equitable*, and may not prevail over A's equity of redemption (as would be the case if a non-dematerialised security were concerned). Because securities are more and more frequently held by intermediaries (which effectively means that legal interests are replaced by equitable ones) the position of third parties acquiring securities tends to worsen. They can no longer fend off A's equity of redemption that easily. According to Benjamin, the recognition of a secured party's general right of disposal would offer collateral takers the legal protection needed.⁹⁸

If Benjamin were to have reasoned in accordance with market practice, however, there would be no problem whatsoever, either in the case of non-dematerialised securities, or in the case of book-entry securities held by intermediaries. Benjamin presupposes that A establishes a security interest in favour of B, on the basis of which B disposes of the encumbered assets in favour of C. In this case A's equity of redemption may indeed pose a problem. By contrast, in the case of an outright transfer by A to B in line with standard market practice, A has no equity of redemption whatsoever. In this case B is fully entitled to dispose of the assets received

96 See, in particular, Articles 6 and 7 of the CD.

97 See section 3.3.3.d ('Extra illustration: the approach under English and American law') of chapter III and section 2 of this chapter.

98 See Benjamin 2000, sections 5.68-69.

from A and to transfer full title to C. C's interest, in this case, is never subject to A's equity of redemption and is fully enforceable.

Moreover, it would be too simple to argue that the equitable rules set out in section 3.4 above can simply be set aside, as would be the result if a right of use on the basis of a security interest were introduced. These rules set out the fundamental characteristics of a security interest, which guarantee that the interests of a collateral provider and a collateral taker are balanced. A security interest without these characteristics, such as a security interest combined with a right of use as envisaged in the Collateral Directive, is essentially an outright transfer. It is submitted that, just as the economic purpose of the outright transfer and the right of use structures is identical, so also should their legal characterisation (and their treatment for tax, accounting and capital adequacy purposes, for example) be the same.

3.6 The Financial Collateral Arrangements (No. 2) Regulations 2003

In the United Kingdom, the Collateral Directive has been implemented by way of the Financial Collateral Arrangements (No. 2) Regulations 2003 (hereafter: 'Regulations'). Section 16 of the Regulations deals with the right of use under a security financial collateral arrangement. It follows fairly closely the text of Article 5 of the Collateral Directive⁹⁹ and reads as follows:

(1) If a security financial collateral arrangement provides for the collateral-taker to use and dispose of any financial collateral provided under the arrangement, as if it were the owner of it, the collateral-taker may do so in accordance with the terms of the arrangement.

(2) If a collateral-taker exercises such a right of use, it is obliged to replace the original financial collateral by transferring equivalent financial collateral on or before the due date for the performance of the relevant financial obligations covered by the arrangement or, if the arrangement so provides, it may set off the value of the equivalent financial collateral against or apply it in discharge of the relevant financial obligations in accordance with the terms of the arrangement.

(3) The equivalent financial collateral which is transferred in discharge of an obligation as described in paragraph (2), shall be subject to the same terms of the security financial collateral arrangement as the original financial collateral was subject to and shall be treated as having been provided under the security financial

99 Note, however, that the somewhat obscure provision of Article 5(4) of the CD has been omitted.

collateral arrangement at the same time as the original financial collateral was first provided.

(4) If a collateral-taker has an outstanding obligation to replace the original financial collateral with equivalent financial collateral when an enforcement event occurs, that obligation may be the subject of a close-out netting provision.

The Explanatory Note to Section 16 of the Regulations only states that:

Regulation 16 provides that where a security financial collateral arrangement provides a right of use for the collateral-taker over the collateral, that term is to be enforceable. Where a right of use is exercised the collateral-taker is obliged to replace the collateral with equivalent financial collateral, unless he sets off the value of the collateral in discharge of the relevant financial obligations in accordance with the terms of the arrangement. The equivalent financial collateral is to be subject to the same terms as the original financial collateral. Obligations arising under right of use provisions in the arrangement may be the subject of a close-out netting provision.

This compact note sheds no light on the conceptual difficulties associated with a secured party's general right of disposal as set out in Benjamin 2000 and in section 3.4 above.¹⁰⁰

3.7 Conclusion

Article 5 of the Collateral Directive, implemented in the United Kingdom by way of Article 16 of the Financial Collateral Arrangements (No. 2) Regulations 2003, provides for the construction of a secured party's general right of disposal. Is this construction compatible with traditional rules of English law?

It is difficult to reconcile a secured party's right of disposal with the equitable rule 'once a mortgage, always a mortgage', with the equity of redemption and, particularly in the case of an unequal power relationship, with the prohibition of collateral benefits. For this reason, the only way a collateral provider can traditionally grant a 'right of use' to a collateral taker under English law is by way of an outright transfer of title.

Market practice confirms that a security interest is not compatible with the collateral taker's general right of disposal. The standard documentation

100 For a more general treatment of the implementation of the Collateral Directive in the United Kingdom, see Fawcett 2005; Turing 2005; Turing / Lester 2005; Hughes 2006.

applied in repo, securities lending and derivatives markets is based on the outright transfer method and does not envisage secured party's general right of disposal under English law. In line with their fiduciary obligations, custodians cannot dispose of their clients' assets unless clients have transferred their assets outright to the custodian. Customarily, such transfers take place on the basis of securities lending arrangements. The doubts in the English prime brokerage markets in relation to a prime broker's right to dispose of collateral assets of its hedge fund clients confirms that there is a tension between the concepts of a security interest and a secured party's general right of disposal.

It is understandable that the financial industry is interested in an alternative to the outright transfer method. The construction of a security interest combined with a general right of disposal is an extra way to make optimal use of assets. One of the main drawbacks of this construction, however, is that it not only blurs the distinction between an outright transfer and a security interest, but also defies the expectations that people in general have in relation to these legal concepts. In the case of an outright transfer, they know they lose all title and interest, whereas they expect to retain ownership if they vest a security interest. The new construction of the Collateral Directive is not in line with these expectations. It enforces the position of the secured party in an unprecedented way.

With regard to content, the construction of a security interest combined with a general right of disposal has most in common with an outright transfer. Until the moment that a collateral taker exercises his right of use, the collateral provider arguably still has his ownership and redemption rights, but these rights are not very strong, because they are not only subject to the collateral provider's own default, but also to the collateral taker's general right of use, which may be exercised at any time. If it is exercised, the collateral provider's proprietary interest is wiped out altogether. The assets to which his right of redemption relates have disappeared for good. Moreover, the Collateral Directive envisages no interest in the proceeds of the sale. Materially, the construction of a security interest combined with a general right of disposal can be equated with an outright transfer of the kind that takes place in repurchase, securities lending and derivatives transactions.

4. RIGHT OF USE UNDER DUTCH (AND GERMAN) LAW

4.1 Introduction

4.1.1 Market practice before the Collateral Directive

Before the implementation of the Collateral Directive, the market standard in the Netherlands was that market participants provided collateral by way of an outright transfer of title. Collateral in repurchase agreements was usually transferred on the basis of a sale/re-sale, whereas collateral in securities lending was usually transferred on the basis of a loan of fungibles (*verbruiklening*, *Darlehen*). This practice is now sanctioned in Article 6 of the Collateral Directive concerning the recognition of title transfer arrangements.¹⁰¹

4.1.2 A new construction: a security interest combined with a general right of disposal

Article 5 of the Collateral Directive makes it possible to provide collateral in another way. According to Article 5, a collateral provider can give a collateral taker a security interest (e.g. a right of pledge) combined with a right of use. This right of use means that the pledgee has the right to dispose of the pledged assets in his own name. He can encumber them with a security interest or sell the assets to a third party. Such a disposal will often leave the pledgor with a contractual claim for the transfer of equivalent assets only, which may be netted with a counterclaim, and which, to the extent that this is not possible (e.g. because of price fluctuations), ranks on a *pari passu* basis in insolvency. A pledge under Dutch and German law is a security right. In principle, a pledgee only has a right to dispose of pledged assets if an event takes place that justifies enforcement of his security right. The right of use implies a pledgee's general right of disposal and is therefore a remarkable development in security law.

4.1.3 Contents of section 4

This section explores whether a right of use based on a security interest fits in the Dutch system of property law. It investigates whether this construction gives rise to tensions in this system, and whether it is compatible with what a security interest actually is, or whether it should with regard

101 See also section 2 of chapter III.

to content be qualified as an outright transfer. Throughout this section a number of comparisons are made with German law. This section approaches the issue by opposing the Collateral Directive's approach of a secured party's general right of disposal to the circumstances under which a party with a limited right (a right of pledge or a right of usufruct) customarily has a right to dispose of the encumbered assets. Sections 4.2-5 on 'enforcement', 'repledge', 'perishable goods' and 'a non-owner's right of disposal granted on a contractual basis' respectively, discuss under which circumstances a pledgee is – or is not – entitled to dispose of the pledged assets under general principles of Dutch law. Section 4.6 on 'irregular structures' examines the theory of irregular pledge, usufruct and custody. This section investigates to what extent these irregular structures coincide with the Collateral Directive's right of use, and pays particular attention not only to the moment at which ownership passes, but also to the question of whether ownership passes through the patrimony of the collateral taker or falls to the third party acquirer directly. An additional topic that arises in connection with the right of use on the basis of a security interest is the rule of proprietary substitution envisaged in the Collateral Directive. This issue is explored in section 4.7. Section 4.8 pays some additional attention to the way the right of use has been implemented into national Dutch and German law. Section 4.9 contains concluding remarks.¹⁰²

4.2 Enforcement

The most important example of a pledgee being entitled to dispose of pledged assets in his own name is enforcement. The pledgee is entitled to realise his security interest only if the obligation in relation to which the right of pledge is vested is not fulfilled.¹⁰³ Note that the right of use under the Collateral Directive goes further, as it entails a right to dispose of encumbered assets under 'normal circumstances'. Because enforcement is not that wide in scope, it cannot serve as a basis for placing the right of use in the system of property law.¹⁰⁴

102 On the right of use under Dutch law, see the Right of Use Report; Keijser 2003 II; Keijser 2004, section 5; Lieverse / Wiggers-Rust 2005, 'Inleiding Van Hees'; Verstijlen 2005, section 4. For German law see for example Löber 2001, in particular section IV.5; Keller 2002, in particular p. 353; Löber 2002; Keller 2003; the Right of Use Report; Löber 2005, pp. 75-76.

103 See Articles 3:227 and 248 of the NCC and § 1204 of the GCC.

104 Cf. Groefsema 1993, section 6.2. For a discussion on the basis of a mortgagee's (*hypothekhouder*) right of disposal upon default under former and current Dutch law,

4.3 Repledge

4.3.1 Dutch law

On the basis of Article 3:242 of the NCC, a pledgor can give a pledgee the right to establish a further right of pledge over the pledged asset for the benefit of a third party. This further right of pledge is established later, but ranks above the initially established right of pledge. The Dutch statutory right to repledge is generally accepted and applied in practice. In order to protect the interests of the original collateral provider, the right to establish a further right of pledge is, in practice, often subject to limitations. These may relate to the height of the debt secured by the further right of pledge, which may not be higher than the original secured debt, or to the term of the debt secured by the further right of pledge, which may not exceed the term of the original secured debt. In legal literature the construction of repledge has raised a number of interpretation issues, including that of the level of protection of the original collateral provider, which are not discussed further in this context. Here, the focus is on the views of Zwolve, who alone has fundamentally criticised the construction.¹⁰⁵

Zwolve has argued that this construction stems from a false interpretation of Roman law. In his view, the proper approach is that under normal circumstances a pledgee has no right of disposal in respect of assets that are not his own¹⁰⁶, and therefore should not be able to establish a further right of pledge in respect of the pledged asset for the benefit of a third party. This view is in line with the nature of a right of pledge, which is a security interest. A pledgee has the right to dispose of the pledged assets only to enforce the security interest, or to guarantee its continued existence (see section 4.4 on perishable goods below). A right to repledge, let alone a general right of disposal, is not compatible with the nature of a right of pledge.¹⁰⁷

see the Asser Series 3-III, no. 298-299, which, for a more elaborate historical treatise, refers to the earlier Asser Series 3-III (11th edition), nos. 318 *et seq.*

105 On the repledge generally, see Asser Series 3-III, nos. 38-39; Groefsema 1993, p. 157 (footnote 12); Koopal 1995, with the reaction of Stokkermans 1996; Fikkers 1998, with the reaction of Faber 1998; Van Hees 2001; Breken 2002. For a reference of a critical nature, see Zwolve 1994.

106 See also Ulpianus D. 50, 17, 54: '*Nemo plus iuris ad alium transferre potest, quam ipse habet*'.

107 Zwolve's approach is exactly that of the German Pandectists and of the drafters of the German Civil Code (see below).

4.3.2 German law

Prior to 1900, when the German Civil Code came into force, the right of repledge was controversial in the German territories, which all had their own jurisdictions. It was not always clear whether a pledgee could only dispose of his claim against the pledgor (and of the accessory right of pledge), or if he could also dispose of the pledged asset itself (with or without the consent of the pledgor) by establishing a right of pledge in respect of that asset for the benefit of a third party. The relevant provisions of the Prussian legislation can be interpreted in both ways.¹⁰⁸ This also holds true for the pledge laws in the Kingdom Sachsen and in Austria.¹⁰⁹ On the other hand, the laws of Bayern clearly only allowed the pledgee to dispose of his own claim and not of the pledged assets.¹¹⁰ This was also true for Swiss law.¹¹¹

Before the introduction of the German Civil Code, the interpretation of Roman law by the so-called Pandectists (*Pandektisten*) played an important unifying role in addition to the laws of the distinct German territories. The Pandectists interpreted Roman law in light of the German society of the nineteenth century. They held that the nature of a right of pledge prohibited a general right of disposal for the pledgee, but did allow a right of disposal that was in line with the security function of the right of pledge (i.e. notably the enforcement of the right of pledge).¹¹²

The approach of the Pandectists was adopted by the drafters of the German Civil Code. The drafters did not approve a disposal of pledged assets that was not in line with the security function of the right of pledge. In their view, such a disposal was not compatible with a pledgee's duty of due care and constituted a penal offence, i.e. illegal appropriation.¹¹³ Under current principles of German law, a pledgee can therefore not establish a right of pledge over the pledged asset for the benefit of a third

108 See §§ 127-138 in Prussia 1794, p. 296-297. See also, with commentaries, Prussia 1840, pp. 375-378; Prussia 1844, p. 501; Prussia 1879, pp. 683-685.

109 See § 475 and §§ 482-483 of the Civil Code of the Kingdom of Sachsen in Sachsen 1863/1865. On Austrian law, see Austria 1872, § 454 and § 455 (in particular footnote 1 on p. 240); Zwalve 1994, pp. 446-447.

110 See Bayern 1821, chapter 6, § XII(1); Bayern 1872, p. 493 (number 2); Bayern 1894, pp. 96-97 (§ 12).

111 See Switzerland 1893, pp. 321-322 (Article 218).

112 See Dernburg 1860, § 61, p. 475-484; Windscheid / Kipp 1906, § 227, p. 1145 *et seq.* See also Zwalve 1994.

113 See the Drafters of the GCC, pp. 803-809 (in particular p. 804).

party. He only has the right to pledge his claim against the pledgor for whom the original, accessory right of pledge was established. Consequently, a right of repledge as envisaged in the Dutch Civil Code is prohibited under German law.

4.3.3 Conclusion

The right of repledge is envisaged in the Dutch Civil Code and is generally accepted and applied in the Netherlands, although subject to certain limitations protecting the original collateral provider. However, as Zwolve and the German Pandectists have convincingly shown, this construction is subject to criticism. It gives the pledgee a right that goes beyond the security function of a right of pledge. For this reason, a right of repledge does not exist under German law. In addition, a right of repledge never entails a pledgee's right to transfer pledged assets outright, as this would disrupt the careful balance that is customarily struck between pledgor and pledgee. The right of use under the Collateral Directive, on the contrary, does entail a right to pledge and to transfer. The right of repledge cannot therefore be a satisfactory explanation for the right of use.

4.4 Perishable goods

Another doctrine that deserves consideration is that of perishable goods. In the case of goods that run the risk of perishing (*drohender Verderb*), § 1219 of the GCC provides for a pledgee's right to sell these goods, if necessary. After the sale, proprietary substitution takes place, i.e. the pledgor has an ownership right in respect of the replacement goods and the pledgee a security interest. Like the Collateral Directive's right of use, the doctrine of perishable goods therefore shows a pledgee's right of disposal combined with a rule of proprietary substitution. The text of § 1219 of the GCC is as follows:

1. If the security of the pledgee is jeopardised by imminent destruction of the pledge or by an apprehended substantial decrease of its value, he may have the pledge sold by public auction.
2. The proceeds take the place of the pledge. The proceeds shall be deposited on the demand of the pledgor.¹¹⁴

114 Translation: Goren 1994. Original German text: '1. Wird durch den drohenden Verderb des Pfandes oder durch eine zu besorgende wesentliche Minderung des Wer-

Dutch law shows a lacuna in this respect. The title of the NCC on the rights of pledge and hypothec (mortgage) of the Dutch Civil Code contains no provision that explicitly allows a pledgee to sell perishable goods. The only provision of the NCC that bears resemblance to the German provision on perishable goods is Article 3:229. This provision sets out a rule on proprietary substitution in relation to pledged assets. Article 3:229 of the NCC reads as follows:

The right of pledge or hypothec (*mortgage*) entails, by law, a right of pledge over all claims for compensation which take the place of the secured property, including claims resulting from its reduction in value []¹¹⁵

However, the parliamentary history of the NCC makes clear that the substitution rule of Article 3:229 of the NCC primarily applies to damages or insurance money due or paid. Perishable goods are neither mentioned in the parliamentary history nor in the literature on the rule of proprietary substitution of Article 3:229 of the NCC.¹¹⁶ For this reason, it is proposed that Article 3:229 of the NCC should be read in combination with Article 6:90 of the NCC. The text of this latter provision is:

1 Where delivery is impeded of a thing which is perishable or subject to rapid deterioration, or, for some other reason, is so difficult to preserve that, in the given circumstances, it cannot be required of the obligor to preserve the same, the latter is entitled to procure the sale of the thing in a proper manner. The obligor is bound to the obligee to make such a sale where the latter's interests clearly require it, or where the obligee indicates that he demands the sale

2 The net proceeds take the place of the thing, without prejudice to the rights of the obligee for any failure in the performance of the obligation¹¹⁷

tes die Sicherheit des Pfandgläubigers gefährdet, so kann dieser das Pfand öffentlich versteigern lassen. 2. Der Erlös tritt an die Stelle des Pfandes. Auf Verlangen des Verpfänders ist der Erlös zu hinterlegen.

115 Translation Netherlands Business Legislation. Original Dutch text: 'Het recht van pand of hypotheek brengt van rechtswege mee een recht van pand op alle vorderingen tot vergoeding die in de plaats van het verbonden goed treden, waaronder begrepen vorderingen ter zake van waardevermindering van het goed. []'

116 See Parliamentary History of the NCC, *Boek 3, Vermogensrecht in het algemeen*, pp 734-736, Asser Series 3-III, in particular nos. 25, 63, 179, Nieuwenhuis 1998, commentary to Article 3:229 of the Dutch Civil Code, Pitlo / Reehuis, Heisterkamp 2001, section 756.

117 Translation Netherlands Business Legislation. Original Dutch text: '1. Bij een verhuizing tot aflevering van een zaak die aan snel tenietgaan of achteruitgaan onderhevig is of waarvan om een andere reden de verdere bewaring zo bezwaarlijk is dat zij in de gegeven omstandigheden niet van de schuldenaar kan worden gevergd, is deze bevoegd de zaak op een geschikte wijze te doen verkopen. De schuldenaar is jegens de schuldeiser tot een zodanige verkoop gehouden, wanneer diens

Article 6:90 of the NCC relates to situations in which the delivery of goods that are perishable, subject to rapid deterioration, or that otherwise cannot reasonably be preserved is impeded. It does not matter if the impediment can be attributed to the creditor or the debtor. A debtor who is under an obligation to deliver the goods described, but cannot, may dispose of the goods concerned. Section 2 of Article 6:90 of the NCC contains a rule on proprietary substitution. The proceeds of the sale of the goods concerned take the place of the goods transferred.¹¹⁸

There are two reasons, though, why Article 6:90 of the NCC may not apply to a pledgee. First, section 1 of Article 6:90 of the NCC requires an 'impediment to delivery'. In the case of a right of pledge one may wonder if there is indeed an impediment for the pledgee to deliver the pledged assets. On the one hand, one can argue that there is no real impediment, because the pledgee simply does not want to give the pledged assets back to the pledgor, as this would mean his claim against the pledgor would become unsecured. On the other hand, and this makes application of Article 6:90 in connection with article 3:229 easier, one could argue that there is an impediment in the form of the secured debt that has not yet been paid. Second, Article 6:90 of the NCC has been positioned in Book 6 on the law of obligations, and not in the Title of Book 3 of the NCC on the rights of pledge and hypothec (mortgage). Still, it can be argued that a pledgee is also under an obligation to deliver the goods concerned in the sense of Article 6:90 of the NCC, even if this obligation follows from the fact that he has a limited right only, and is not the owner of the goods. In any case, the desired result, which is reached under German law by an explicit statutory provision, is of a pledgee who may dispose of perishable goods. In order to resolve this problem, one solution would be to read Article 3:229 of the NCC in conjunction with Article 6:90 of the NCC, interpreted liberally.

However that may be, the German regulation on perishable goods (and its possible Dutch counterpart as described above) cannot serve as a basis for implementation of Article 5 of the Collateral Directive. There are, of

belangen deze verkoop onmiskenbaar eisen of de schuldeiser te kennen geeft de verkoop te verlangen 2 De netto-opbrengst treedt voor de zaak in de plaats, onverminderd de rechten van de schuldeiser wegens tekortkomingen in de nakoming van de verbintenis'

118 See the Parliamentary History of the NCC, *Boek 6, Algemeen gedeelte van het verbintenissenrecht*, pp. 317-319. See also Groefsema 1993, p. 158 Cf. Articles 7:30 and 8:491 of the NCC

course, certain similarities. Both the provision on perishable goods and Article 5 of the Collateral Directive envisage a pledgee with a right of disposal and a rule of proprietary substitution in order to preserve the pre-sale proprietary structure. Still, there are also important differences. First, securities are not necessarily 'perishable goods'. They can only be considered to be so in the case of extreme price fluctuations in the market. The second argument relates to the different objectives of the German law provision and the Collateral Directive. The German arrangement in respect of perishable goods has only the limited goal of protecting the pledgor's security interest, and therefore serves only the recovery function of collateral. The right of use under the Collateral Directive, on the other hand, has a considerably wider scope. It not only allows dispositions in the event of deterioration, but aims at a general right of disposal in respect of collateral assets under all circumstances. It aims at tradeability, rather than at maintaining the recovery function of financial collateral provided. For these reasons, the regulation on perishable goods cannot serve as a satisfactory basis for integrating the right of use in the Dutch and German systems of property law.¹¹⁹

4.5 A non-owner's right of disposal granted on a contractual basis

4.5.1 Introduction

a. *A non-owner's right of disposal*

Normally, the owner of an asset is entitled to dispose of that asset. There are, however, instances in which someone who is not the owner of an asset can have the right to dispose of that asset in his own name (hereafter indicated as a 'non-owner's right of disposal'). A few examples of a non-owner's right of disposal have already been discussed above. When a pledgee enforces his security interest, he disposes of the assets of the pledgor in his own name (see section 4.2 above). When a pledgee exercises a right of repledge under Dutch law, he disposes of the asset of the pledgor in his own name (see section 4.3 above). Dispositions by a pledgee in his own name in relation to perishable goods were discussed in section 4.4 above. Dispositions by a usufructuary in his own name are dealt with below in section 4.6.3. In all these cases, dispositions by a non-owner are based on an explicit legal provision, while consent of the

119 For a further discussion of the Collateral Directive's rule on proprietary substitution, see section 4.7 below.

original owner is not – with the exception of the Dutch repledge – required.

This section focuses on a number of legal constructions that show that a non-owner's power to dispose of someone else's assets in his own name can also be based on a contract.¹²⁰ The most important of these to be discussed are the sale on commission, reservation of title arrangements and the fiduciary transfer of title. The concept of a non-owner's right of disposal on a contractual basis is often referred to as *machtiging* in the Netherlands, and *Ermächtigung* in Germany.¹²¹

It should be stressed from the outset that the concept of a non-owner's right of disposal cannot be classified as one that belongs purely to the law of obligations. Although such a right is granted on the basis of a contract, it also has marked proprietary features because it gives a non-owner the right to dispose of assets that are not his own. Whereas a right of pledge can easily be combined with rights and obligations of a purely obligatory nature, such as a pledgee's obligation to insure encumbered assets, it is exactly this proprietary feature of the concept of a non-owner's right of disposal that leads to tensions when it is applied in connection with the proprietary right of pledge.

b. Dutch law

Under current Dutch law, there are two important applications of the concept of a non-owner's right of disposal on a contractual basis. These are: the contract of mandate (*lastgevingsovereenkomst*), which is, among other things, used to structure a sale on commission, and reservation of title arrangements.

It follows from Articles 7:414-424 of the NCC, that in a sale on commission an intermediary can be given the right to sell the principal's assets in the name of the principal (an example of direct representation), or in his own name (indirect representation). In the case of indirect representation, the

120 A general right of disposal can also be granted on the basis of a unilateral legal act, but hereafter the focus is on such a right granted on the basis of a bilateral agreement.

121 For Dutch law, see, for example, Groefsema 1993; Asser Series 2-I, chapter III, § 6; Asser Series 5-III, p. 139. For German law, see the literature mentioned in footnote 125.

intermediary (a non-owner) disposes in his own name of the assets of another entity on the basis of a contract.¹²²

Likewise, in a reservation of title, the buyer (not yet a full owner, but the owner under the condition that the sale price will be paid) can, if this follows from the contractual relationship with the original owner, dispose in his own name of the original owner's goods in the normal course of business, even before paying the sale price. In the absence of a statutory provision comparable to Articles 7:414-424, several theories have been developed in to explain the basis of this right of disposal.¹²³ The reservation of title arrangement can, in line with Article 3:92 of the NCC, be seen as a transfer under the condition of payment of the sale price or of a subsequent transfer in the normal course of business of the buyer. If one of these conditions is fulfilled, the buyer can dispose of the assets involved in his capacity of a full owner. Because of this, however, this first theory is not an application of a non-owner's right of disposal. Another way to explain the buyer's right to dispose in his own name of the original owner's assets in the normal course of business is through accepting that the original owner can extend this right to the buyer on the basis of a contract. Hereafter, the focus will be on the latter theory, because it is in this case that, like the Collateral Directive's disposing pledgee, a non-owner disposes in his own name of another entity's assets.

Both the sale on commission and reservation of title arrangements therefore show that under Dutch law an owner can contractually grant a non-owner the right to dispose in his own name of the owner's assets.¹²⁴

c. *German law*

Under German law, the concept of a non-owner's right of disposal on a contractual basis has an explicit legal basis. §§ 182-185 of the GCC

122 For more on 'direct' and 'indirect' representation, see chapter 3 ('Authority of Agents') of the Principles of European Contract Law.

123 On these theories, see Asser Series 2-I, chapter III, in particular sections 135-136; Asser Series 3-III, in particular sections 428-428a; Reehuis 1998, chapter 8, in particular section 38. See also the Supreme Court's verdict of 8 June 1973 (*Nationaal Grondbezit N.V. / Kamphuis*), published in *Ars Aequi* 1973, pp. 565-571, with an annotation by Van der Grinten and in *Nederlandse Jurisprudentie* 1974, no. 346, with an annotation by Kleijn.

124 For Dutch law see, for example, Asser Series 2-I, chapter III; Asser Series 5-III, chapter III, in particular §§ 4 and 5; Van der Grinten 1993 I; Van der Grinten 1993 II; Groefsema 1993; Meijer 1999, in particular chapter 5; Pitlo / Reehuis, *Heisterkamp* 2001, no. 141; Reehuis 1998, chapter 8.

constitute title 6 on *Einwilligung* and *Genehmigung*. Whereas *Einwilligung* is a form of consent that is given beforehand, the *Genehmigung* relates to consent that is given after a legal act has already been carried out. Both forms of consent fall within the general category of *Zustimmung* (see § 182 of the GCC). In this section, the focus is on § 185 of the GCC, which relates to acts of disposal by a non-owner (*Verfügung eines Nichtberechtigten*). On the basis of this provision, someone who is not an owner can dispose of the assets of someone else, if (1) the person entitled has given his consent in advance (*Einwilligung*), (2) that person has consented afterwards (*Genehmigung*), (3) the non-owner becomes entitled to the assets because he acquires or inherits them. Because the Collateral Directive presumes consent in advance in respect of a right of use, it is § 185(1) of the GCC, relating to the *Einwilligung*, that is most interesting here. As in Dutch law, the most important applications of the doctrine of a non-owner's right of disposal under German law are (1) the disposal by an intermediary in the case of a sale on commission, and (2) the disposal by the first buyer in the case of a reservation of title arrangement. Another important application of the concept of a non-owner's right of disposal is (3) a fiduciary transfer of title, which is not allowed under current Dutch law but is commonly applied under German law. In the case of a fiduciary transfer of title, even though title has passed to the fiduciary, the original owner is allowed to dispose of the goods transferred under certain circumstances.¹²⁵

d. *The objective of section 4.5*

The sections below investigate whether the concept of a non-owner's right of disposal granted on a contractual basis can be used to explain the pledgee's right to dispose of pledged assets as envisaged in Article 5 of the Collateral Directive. Under both Dutch and German law, the concept of a non-owner's right of disposal is applied in a sale on commission and reservation of title arrangements, topics discussed in sections 4.5.2 and 4.5.3 below. Section 4.5.4 focuses on the concept of a non-owner's right of disposal in fiduciary transfers of title under German law. Section 4.5.5 subsequently examines the principal question of whether it is possible to grant a pledgee an unlimited right of disposal, and considers this question in light of core principles of pledge law.

125 For the scope of § 185(1) of the GCC see the Munich Commentary, Volume 1, 4th edition, § 185, no 35-37, Palandt Commentary, 64th edition, § 185, section 9, Soergel Commentary, 13th edition, § 185, no. 23, Staudinger Commentary, 2001, § 185, no 32-45. See also Serick 1990 and Groefsema 1993, section 4 5

4.5.2 Sale on commission

This section discusses the sale on commission, in which an intermediary sells a principal's assets to a third party in his own name. Under Dutch law, a sale on commission is structured as an agreement of mandate (*lastgevingsovereenkomst*). The NCC contains a special section on agreements of mandate (see Articles 7:414-424 of the NCC), which is part of the general title 7.7 on services (*opdracht*).¹²⁶ Under German law, the concept of a sale by an intermediary to a third party in his own name can be explained with the help of § 185 of the GCC. A detailed regulation on the sale of commission is set out in §§ 383-406 of the German Commercial Code (*Handelsgesetzbuch*).

A sale on commission and the Collateral Directive's right of use have this in common: they both feature a non-owner's right of disposal. In a sale on commission, an intermediary disposes in his own name of the assets of a principal. In cases involving the right of use, a pledgee disposes in his own name of the assets of a pledgor.

There are, however, also principal differences between the sale on commission and the right of use. These become apparent when one compares the structure of these two legal constructions. A sale on commission is structured as follows:

Sale on commission

At moment T=1, a principal A and an intermediary B conclude an agreement of mandate, on the basis of which the intermediary sells and delivers the principal's assets to a third party C in his own name at moment T=2. The price paid by C to B at moment T=2 must subsequently be transferred by B to A at moment T=3.

The structure of the right of use envisaged in the Collateral Directive is entirely different:

¹²⁶ Before the current NCC came into force, the Dutch Commercial Code contained an explicit regulation on the sale on commission. See the old Articles 76-85a of the Dutch Commercial Code in Fruin 1990. See also Asser Series 5-III, section 136.

Security interest combined with a right of use

At T=1, A receives euros from B and vests a security interest combined with a right of use in return. At T=2, B exercises his right of use and transfers A's assets to C in exchange for a sum of money. Because of his obligation to transfer equivalent assets to A at T=4, B acquires equivalent assets in the market from D at T=3.

A number of important differences between a sale on commission and a right of use are summarized as follows:

1. In a sale on commission, A usually receives payment only at T=3. In the right of use scenario, A has already received a counter-performance at T=1.
2. In a sale on commission, A is the owner until B has lawfully disposed of the assets in the ordinary course of business. After that moment, A has an unsecured exposure towards B. In the right of use structure, both A and B are secured throughout the transaction in the sense that their risks are covered by a counter-performance that is available for netting if anything should go wrong.¹²⁷
3. In a sale on commission, there is no obligation to deliver equivalent assets at the end of a transaction for any of the parties, but only an obligation for B to pass on the sale price (minus a commission fee). If a right of use has been granted, A and B must transfer equivalent assets.
4. In a sale on commission, the intermediary acts for the account of the principal and in one way or another always represents the principal's interests, for which he is usually awarded with a fee. In the case of the

¹²⁷ Under the Collateral Directive, such netting is intended to be enforceable. For more information on this issue, see section 3 of chapter V.

right of use, the 'pledgee' does not act for the account of the original owner or represent the original owner's interests. Rather, the pledgee disposes of the assets concerned in the course of his own business in order to make profit for his own benefit.

A sale on commission and the right of use have in common that they both feature a disposing non-owner. Still, the sale on commission cannot serve as a sufficient basis for implementation of the right of use. A comparison of the two legal constructions shows that they have different objectives and that they are structured in different ways.

4.5.3 *Reservation of title arrangements*

The principal goal of a reservation of title arrangement, such as the Dutch *eigendomsvoorbehoud* or the German *Eigentumsvorbehalt*, is security for the seller. From an economic point of view, the seller is the collateral taker, whereas the buyer agrees to the reservation of title and can thus be considered to be the collateral provider. This section focuses on the circumstance that the buyer can, in the case of a reservation of title arrangement under both Dutch and German law, be granted the right to dispose of the original owner's assets in his own name, in the course of his own business and for his own benefit. This right guarantees the continuation of business activities. Whether the buyer has this right must be determined on the basis of the contractual relationship between the parties.¹²⁸

At first sight, the right of use seems similar to reservation of title arrangements. Both allow a non-owner to dispose of another entity's assets in his own name and – unlike in the case of the sale on commission – for his own account and in the course of his own business.

Still, there are a number of differences between a reservation of title arrangement and a right of use, which become apparent when one compares the structure of these two legal constructions. The structure of a reservation of title arrangement is as follows:

128 For the circumstances under which a buyer has a right of disposal under Dutch law, see the Supreme Court's decision of 14 February 1992 (*Hinck / Van der Werff*), published in *Nederlandse Jurisprudentie* 1993, no. 623. For German law, see the literature mentioned in footnote 125.

Reservation of title

At T=1, A transfers assets to B, but reserves title in respect of the assets until B pays the sale price or disposes of the assets in the normal course of his business. At T=2, B sells and delivers the assets to C and receives euros in return. At T=3, B pays A for the assets.

This structure is essentially different from that of a security interest combined with a right of use (as depicted in section 4.5.2 above). Without being exhaustive, a number of important differences are:

1. If title is reserved, A receives payment only at T=3. In the right of use scenario, A has already received a counter-performance at T=1.
2. In a reservation of title arrangement, A is the secured party wishing to reserve his ownership interest, in any case, until B has paid the sale price or has disposed of the assets in the normal course of business. After the moment of such a disposal by B, A has an unsecured exposure towards B. In the right of use structure, both A and B are secured throughout the transaction in the sense that their risks are covered by a counter-performance that is available for netting if anything should go wrong.¹²⁹
3. If title to assets is reserved, there is no obligation to deliver equivalent assets at the end of a transaction for any of the parties, but only an obligation for B to pay for the originally transferred assets. If a right of use has been granted, A and B must transfer equivalent assets.
4. Another difference is that in a reservation of title arrangement, it is not the secured party (i.e. the original owner) who has an unlimited right of disposal, but his counterparty (the first buyer), who has consented to the reservation of title and can thus be considered as the collateral provider. In the case of a 'right of use', however, it is the collateral taker who has a general right of disposal.

129 Under the Collateral Directive, such netting is intended to be enforceable. For more information on this issue, see section 3 of chapter V.

As in the case of the Collateral Directive's right of use, a reservation of title arrangement can feature a non-owner who is entitled to dispose in his own name of assets that belong to another entity, in the course of his own business and for his own benefit. Nonetheless, the structure of a reservation of title arrangement deviates so much from that of the right of use (e.g. it features a collateral *provider's* right of disposal and not that of the collateral *taker*), that it cannot be used as a theoretical explanation for the right of use.

4.5.4 Fiduciary transfer of title

The commentaries to § 185(1) of the GCC make clear that in a fiduciary transfer of title, the original owner can be given a right of disposal.¹³⁰ There are several reasons why parties may opt for the establishment of a non-possessory security interest, such as the fiduciary transfer of title. The original owner may need the goods given in security (e.g. machinery) for the continuation of his enterprise. He may want to process them, or he may want to dispose of the assets in the normal course of his business, which is one reason why he can be granted a right of disposal. Whether the original owner has this right must be determined on the basis of the contractual relationship between the parties.¹³¹

The structure of a fiduciary transfer of title is as follows:

Fiduciary transfer of title

At moment T=1, owner B transfers assets on a fiduciary basis to A in order to secure a loan from A to B. From that moment, A is the fiduciary owner of those assets and B the beneficiary. At moment T=2, B transfers the assets in the normal course of

130 See the Munich Commentary, Volume 1, 4th edition, § 185, no. 35-37; Palandt Commentary, 64th edition, § 185, section 9; Soergel Commentary, 13th edition, § 185, no. 23; Staudinger Commentary, 2001, § 185, no. 32-45.

131 See Serick 1990, in particular pp. 55-56. On fiduciary transfers of title, see also section 3.2 of chapter III.

business to C in exchange for a sum of money. At moment $T=3$, B repays the loan to A.

Both in the case of a fiduciary transfer of title and the Collateral Directive's right of use it can be agreed that a non-owner (the original owner or the pledgee respectively) has a right to dispose of assets in his own name and for his own benefit. Still, the structures of these two constructions are essentially different.¹³² The main differences between a fiduciary transfer of title and the right of use are the following:

1. In the structure described above, which involves a fiduciary transfer of title, B repays the loan to A only at $T=3$. In the right of use scenario, A has already received a counter-performance at $T=1$.
2. In a fiduciary transfer of title, A is the secured party until B has repaid the loan or has lawfully disposed of the assets in the ordinary course of business. After such a disposal at moment $T=2$, A merely has – in the absence of an additional agreement – an unsecured exposure towards B. In the right of use structure, both A and B are secured throughout the transaction in that their risk is covered by a counter-performance that is available for netting if anything should go wrong.¹³³
3. In a fiduciary transfer of title, there is no obligation to deliver equivalent assets at the end of a transaction for the parties, but only an obligation for B to pay off the loan. If a right of use has been granted, A and B must transfer equivalent assets.
4. In a fiduciary transfer of title, it is not the secured party (i.e. the fiduciary A), but the collateral provider (i.e. the original owner B) who can be granted a right to dispose of the goods transferred. In the case of the right of use of the Collateral Directive, it is the collateral taker who has an unlimited right of disposal.

The structures of a fiduciary transfer of title and the Collateral Directive's right of use differ in many respects. One of the principal differences is that under a fiduciary transfer of title, it is the collateral provider who may have a general right of disposal and not the collateral taker. Therefore, the

132 Cf. the structure of the Collateral Directive's right of use set out in section 4.5.2 above.

133 Under the Collateral Directive, such netting is intended to be enforceable. For more information on this issue, see section 3 of chapter V.

original owner's right of disposal in the case of a fiduciary transfer of title cannot serve as a basis for the right of use.

4.5.5 *A pledgee's contractually granted general right of disposal?*

a. A theoretical possibility

Even if a collateral taker does not customarily have a general right of disposal in, for example, reservation of title arrangements or fiduciary transfers of title (see sections 4.5.3 and 4.5.4 above), it is theoretically possible that a secured party is granted such a right on the basis of a contract.

Additional inspiration for this approach can be drawn from German law, which seems to defend the application of a contractually granted general right of disposal in connection with a loan agreement or a right of usufruct. A borrower or a usufructuary can, in this view, be given a general right of disposal on the basis of a contract. This allows the contracting parties a level of flexibility.¹³⁴ A drawback of this view though, is that it leads to a fading of the distinction between a loan and a loan of fungibles, and between a right of usufruct and an irregular right of usufruct. Both a loan of fungibles and an irregular right of usufruct entail a passing of ownership. It is probably because of this drawback that Dutch law customarily takes a different approach in this respect than German law. A loan agreement combined with a general right of disposal and an obligation to transfer equivalent assets at a later date is customarily characterised as a loan of fungibles and entails a passing of ownership. A right of usufruct combined with a usufructuary's general right of disposal and an obligation to transfer equivalent assets was, under old Dutch law, designated as an irregular right of usufruct and, likewise, led to a passing of ownership. Under the current Dutch Civil Code, however, it is possible to grant a usufructuary a general right of disposal.¹³⁵

Explaining the collateral taker's right of use as envisaged in the Collateral Directive by referring to the concept of a contractually granted general right of disposal has a number of advantages. This approach is compatible

134 See e.g. Palandt Commentary, 64th edition, § 607, section 6; Palandt Commentary, 64th edition, § 1067.

135 On the loan of fungibles see also section 2.4.2 of chapter III and section 4.6.2 of this chapter. On the irregular right of usufruct under German and old Dutch law and on the advantages and disadvantages of the new approach in this respect in the current Dutch Civil Code, see in particular section 4.6.3 below.

with the approach of the Collateral Directive, according to which the collateral provider loses ownership only at the moment that the collateral taker exercises his right of use, and not at the moment that the right of disposal is granted. The Collateral Directive suggests that until that moment the collateral provider has an unimpaired ownership interest.¹³⁶ Furthermore, it can help in determining whether ownership passes through the patrimony of the collateral taker or passes directly from the collateral provider to the third party acquirer.¹³⁷

Still, one wonders why the construction of a secured party's general right of disposal has never developed under either Dutch or German law. Whereas a loan agreement and a right of usufruct may leave some room for a contractually granted general right of disposal, the same is not true for the right of pledge. To my knowledge, the view that a secured party can be granted an unlimited right to dispose of encumbered assets on the basis of a contract has never been defended in Dutch or German legal literature. The next subsection investigates why this is the case, and why the Collateral Directive's right of use puts pressure on systems of Dutch and German property law.

b. Pressure on the system of property law: no compatibility with core principles of pledge law

This section investigates the relationship between the proprietary right of pledge and the proprietary construction of a non-owner's right of disposal. Whether these two legal constructions are compatible can best be investigated by considering the consequences of combining the two.

One of the first problems to arise relates to the prohibition of repledge under German law (see section 4.3). Essentially, this prohibition makes it impossible to grant a pledgee more rights than a right to have recourse to the encumbered assets. He is not allowed a right of disposal enabling him to repledge the encumbered assets in order to secure his own debt. In this light, an even more comprehensive, general right of disposal is quite unacceptable.

More importantly, a pledgee's general right of disposal is not compatible with essential characteristics of security interests under both Dutch and

136 For a further elaboration on this issue, see section 4.6.4 below.

137 For a further elaboration on this issue, see section 4.6.5 below.

German law. A security interest, such as a right of pledge, is by its nature a limited right that only gives the pledgee the right to dispose of encumbered assets if the secured debt is not fulfilled. A pledgee's contractually granted, unlimited right of disposal is diametrically opposed to such a limited right of disposal. The right of pledge combined with a right of use is no longer a security interest, which serves recourse purposes, but acquires a much wider scope. Furthermore, a pledgee's general right of disposal cannot be reconciled with the pledge principles outlined in section 1.3 of chapter III. When a pledgee disposes of the encumbered assets, he essentially appropriates them. This is contrary to the prohibition of appropriation under Dutch and German law. After a disposal by the pledgee, the pledgor is no longer able to redeem his assets by fulfilling the secured obligation, because the assets are now owned by a third party. Moreover, a general right of disposal cannot be reconciled with a pledgee's duty of due care.¹³⁸

The core argument against combining a right of pledge with a pledgee's general right of disposal is that this combination disturbs the careful balance that legislators and courts have customarily struck between the interests of collateral providers, their creditors and collateral takers. The principles mentioned above all reflect that the parties involved in a security arrangement are engaged in a special, fiduciary relationship in which their respective interests are balanced. One of the main objectives of the pledge principles is to protect the interests of a weaker collateral provider, who is often in a dependent position because he is in need of funding, and to protect his other creditors against what is usually a stronger collateral taker. A general right of disposal essentially gives the collateral taker the power to decide whether the fiduciary relationship between the parties continues to exist. This is at odds with the notion of protecting the collateral provider and his creditors, which lies behind the characteristics of security interests.

As was already indicated in section 4.5.1.a, a non-owner's general right of disposal is a construction which, though granted on the basis of a contract, has distinct proprietary features. The above clearly shows that there is friction between this proprietary construction and the proprietary right of pledge. In my view, the scope of a non-owner's right of disposal is subject to limitations. It has value in the sale on commission. It also

138 Comparable principles apply in the case of a fiduciary transfer of title. See section 3.2 of chapter III.

explains why a collateral provider can dispose of assets in a reservation of title arrangement, and, under current German law, in a fiduciary transfer of title. Moreover, under German law its application in connection with a loan agreement or with a right of usufruct is sometimes also defended. In my view, however, it cannot be applied in connection with a right of pledge, as it distorts what a right of pledge essentially is.

The question remains: what to do if a provision in a pledge agreement nevertheless envisages the pledgee's general right of disposal? One initial option would be to declare the respective provision void or voidable.¹³⁹ Under Dutch law, this could be based on Article 3:40 of the NCC, which prohibits legal acts which violate a mandatory statutory provision, for example, those of pledge law. Under German law, this could be based on § 138 of the GCC, which prohibits extortion, e.g. in the relationship between a stronger collateral taker and a weaker collateral provider. Whereas this solution may be available under principles of general law, it is very unlikely that it can be applied in the context of the Collateral Directive, which explicitly envisages a secured party's right of disposal.

Another solution, which seems the most appropriate in the case of the Collateral Directive, and which can also be applied in other cases, is to do justice to the intentions of the parties and to convert their arrangement accordingly. See, for example, § 140 of the GCC:

If an invalid legal act corresponds to the requirements of another legal act, the latter will apply, if it is plausible that its application would have been desired if the parties had known of the invalidity.^{140 141}

As is shown in section 4.6 below, it is the 'irregular right of pledge' that can best be used in order to interpret the Collateral Directive's right of use. An irregular pledge has essentially the same structure as a security interest combined with a right of use. In an irregular pledge a 'pledgor' grants a 'pledgee' a general right of disposal, whereas the 'pledgee' is under the obligation to transfer equivalent assets at the end of the transaction. Because a pledgee's general right of disposal is not compatible

139 See, for example, Benjamin 2000, sections 10.57-10.59, and p. 117 (footnote 101); Benjamin / Yates / Montagu 2002, section 4.34. See also section 3 above.

140 Translation: TK. Original German text: 'Entspricht ein nichtiges Rechtsgeschäft den Erfordernissen eines anderen Rechtsgeschäfts, so gilt das letztere, wenn anzunehmen ist, dass dessen Geltung bei Kenntnis der Nichtigkeit gewollt sein würde.'

141 On recharacterisation under English law, see also the sources mentioned in footnote 139.

with the fiduciary protection mechanisms that are characteristic of a right of pledge, such an irregular right of pledge entails a transfer of ownership.

4.6 Irregular structures

4.6.1 Introduction

In addition to the theory of a non-owner's contractually granted right of disposal, a more traditional theory relating to 'irregular' structures is available to explain a pledgee's, usufructuary's or custodian's general right of disposal. This theory is discussed in this section. Section 4.6.2 below focuses on the irregular right of pledge under Dutch and German law, in light of other irregular structures, such as the irregular right of usufruct and irregular custody. Because of changes to the Dutch Civil Code in 1992, it is necessary to consider the new Dutch regulation on the (irregular) right of usufruct in section 4.6.3. Particular attention is also paid to the moment at which ownership passes under the irregular structures, and to whom. These issues are dealt with in sections 4.6.4 and 4.6.5 respectively.

4.6.2 Irregular right of pledge

Consumable goods (*verbruikbare goederen*, *Verbrauchbare Sachen*) are goods that can be used up or disposed of. Securities are consumable goods in that they are often traded. It is exactly this feature of securities that plays a key role in the Collateral Directive.¹⁴²

How should a right of pledge, a right of usufruct or custody in respect of such consumable goods be characterised? In Dutch and German literature, it has been argued that in all these cases ownership passes if the assets are made 'replaceable'. Replaceable means that the pledgee, usufructuary or custodian is allowed to dispose of the assets while being under an obligation to transfer back equivalent assets. In this case, the doctrine speaks of 'irregular pledge', 'irregular usufruct' and 'irregular custody' respectively.¹⁴³

142 According to Meijer 1974, pp. 4-6, securities are consumable goods. Under German law securities are also considered consumable goods. See § 92 of the GCC (*verbrauchbare Sachen*) and the comments thereto in the Munich Commentary, Volume 1, 4th edition, pp. 919-920; Palandt Commentary, 64th edition, § 92.

143 On Dutch law, see Hammerstein 1977, chapter 4; Houwing in Van Hall / Houwing 1952, pp. 165-228; Van Gaalen 2001, nos. 022 and 153; Meijer 1974, pp. 3-27. On the

In Dutch literature, Meijer has argued that a custody arrangement implies a passing of ownership if the custodian is allowed to dispose of the assets given in custody while being under an obligation to pay equivalent assets at a later date. She states: 'This is no longer custody, but a loan of fungible assets. The client loses the ownership of the assets at the moment he places them in custody [...].'¹⁴⁴

Houwing and Van Ardenne-Stachiw argue that a client loses his proprietary interest when he gives securities in custody or pledges them to a custodian, who has a right to replace the securities provided with securities of the same kind but with different numbers (*recht van nummer-verwisseling*). Such a right means that a custodian can dispose of the securities of his clients, but must replace those securities by equivalent securities of which the number may be different. Van der Grinten has also discussed the right to replace securities with securities with different numbers. He describes the situation in which a custodian has the right to replace securities in which he has a right of pledge. In the view of Van der Grinten, such an arrangement is incompatible with the pledgor's ownership right because this right no longer attaches to specified assets. He argues that, in this case, fiduciary ownership passes to the custodian. The relationship arising between the client and the custodian is indeed of a fiduciary nature if the custodian cannot dispose freely of the assets given in custody, but must take the interests of his client into account. It can, however, be argued that an unconditioned passing of ownership to the custodian takes place if the custodian has an unconditioned right of disposal, and can dispose of the assets for his own business purposes.¹⁴⁵

Following Houwing, Hammerstein has developed a more generally applicable theory in respect of consumables that are made replaceable. Both authors argue that a pledgee, usufructuary or custodian who is allowed to dispose of consumables in exchange for equivalent assets

German irregular pledge, see the Staudinger Commentary, (Neubearbeitung 2002), § 1204, no. 52-60. The irregular usufruct has been codified in § 1067 of the German Civil Code.

144 See Meijer 1974, pp. 3-27. Quotation: p. 27. Translation: TK. Original Dutch text: 'Dit is geen bewaargeving meer, maar verbruiklening. De 'bewaargever' verliest de eigendom van de ingeleverde stukken op het moment van de overgifte [...].'

145 See Houwing in Van Hall / Houwing 1952, p. 170; Van Ardenne-Stachiw 1985, section 2.6.5; and Van der Heijden / Van der Grinten 1989, pp. 327-328. Note that the topic of a right to change the numbers of securities is not discussed in the 12th edition of the Van der Heijden / Van der Grinten manual.

becomes the owner of the consumables. Hammerstein states that making a consumable asset replaceable means that:

the ownership passes to the entity to whom the asset has been handed over. As a result, the proprietary claim of the owner is transformed into a contractual claim for the delivery of equivalent assets. [...] It could be argued that the *causa* is, in this case, the right to use up the asset or to use it (which use would, in this instance, include a right to dispose of the asset), while the transferee is under an obligation to transfer equivalent assets or the value thereof at the end of the relationship between the parties.¹⁴⁶

In such cases there is an irregular pledge, an irregular right of usufruct or an irregular custody relationship.¹⁴⁷

Van Setten has argued that the right of use of the Collateral Directive is essentially a loan of fungibles.¹⁴⁸ In the case of a loan of fungibles assets are also made replaceable. Therefore, as under the irregular structures, a loan of fungibles entails a transfer of ownership.¹⁴⁹

The doctrine of replaceability also plays a role in German law when considering consumable assets. When a pledgee has the right to dispose of such assets in exchange for an obligation to deliver equivalent assets, this is qualified as an irregular pledge, and ownership passes.¹⁵⁰ Likewise, an irregular right of usufruct (further discussed in section 4.6.3 below) and a loan of fungibles (*Sachdarlehen*; see §§ 607-609 GCC) under German law as a standard entail a passing of ownership.¹⁵¹

146 See Hammerstein 1977, pp. 135-136. Translation: TK. Original Dutch text: '[...] het vervangbaar stellen van een zaak betekent dat de eigendom overgaat op degene aan wie men de zaak ter hand stelt. De zakenrechtelijke aanspraak van de eigenaar verandert daardoor in een obligatoire vordering tot teruggave van een soortgelijke zaak. [...] Als titel van eigendomsverkrijging zal kunnen worden aangevoerd dat de zaak verbruikt mag worden of in de meest ruime zin gebruikt (hetgeen in dit verband dan ook een bevoegdheid tot vervreemding zou impliceren) onder de verplichting aan het einde van de rechtsverhouding een soortgelijke zaak of de waarde daarvan terug te geven.'

147 See Hammerstein 1977, chapter IV. In the same sense Houwing in Van Hall / Houwing 1952, pp. 165-228.

148 See Dalhuisen / Van Setten 2003, pp. 140-141.

149 See section 2.4.2 of chapter III.

150 On the '*unregelmässiges Pfandrecht*' or '*pignus irregulare*' see the Staudinger Commentary, (Neubearbeitung 2002), § 1204, no. 52-60.

151 See Palandt Commentary, 64th edition, § 607; Palandt Commentary, 64th edition, § 1067. See also section 2.4.2 of chapter III.

Both under Dutch and German law, therefore, the general rule is that ownership passes if consumable assets are made replaceable (which means that the receiver of the assets has the right to dispose of them, while being under an obligation to deliver equivalent assets).¹⁵²

Taking into account that Article 5 of the Collateral Directive relates to security interests, it is most feasible to consider the right of use as an irregular pledge. The structure of an irregular pledge is essentially as follows:

Irregular pledge

This structure is exactly the same as the structure of a security interest combined with a right of use as envisaged in the Collateral Directive.¹⁵³ Such a security interest combined with a right of use is therefore essentially an irregular pledge. In line with the Dutch and German doctrine on irregular pledge, usufruct and custody, the conclusion must therefore be drawn that the right of use under the Collateral Directive entails a passing of ownership.¹⁵⁴

152 The exact moment at which the original owner loses his proprietary interest, and to whom, is discussed in more detail in sections 4.6.4 and 4.6.5 below.

153 See the diagram in section 4.5.2 above.

154 The irregular pledge has been suggested in German literature as a way of implementing Article 5 of the CD. See Löber 2001; Keller 2002; Löber 2002; Keller 2003. See also section 4.8 below.

4.6.3 Irregular right of usufruct

a. Introduction

A separate section is devoted to the (irregular) right of usufruct. The reason being that under the current Dutch Civil Code, a usufructuary has a general right of disposal if the right of usufruct is vested in respect of consumable goods. This is remarkable because a right of usufruct, like a right of pledge, is, after all, a limited proprietary right. A right of usufruct is normally confined to making use of assets or to enjoying their fruits, and does not entail a general right of disposal. Moreover, as in the Collateral Directive, the Dutch legislator has envisaged a rule of proprietary substitution in connection with the general right of disposal of the usufructuary. This section investigates whether the new right of usufruct, combined with a right of disposal and a rule of proprietary substitution, can serve as a basis for implementing the Collateral Directive's right of use.

b. German law

The German approach in respect of the irregular right of usufruct (*Nießbrauch*) is a clear example of the theory discussed in section 4.6.2 above on consumable goods. On the basis of § 1067 of the GCC, the person who has a right of usufruct in respect of consumable goods (*verbrauchbare Sachen*) is the owner of these goods. The text of § 1067 of the GCC is as follows:¹⁵⁵

1 If a right of usufruct relates to consumable assets, the usufructuary becomes the owner of these assets, upon the termination of the right of usufruct he should compensate the original owner for the value which the assets had at the moment the right of usufruct was vested. Both the original owner and the usufructuary can at their own cost have the value determined by a specialist.

2 The original owner can request security when the claim for the compensation of the value is endangered.¹⁵⁶

155 See also §§ 1075(2) and 1084 of the GCC.

156 Translation TK. Original German text: '1 Sind verbrauchbare Sachen Gegenstand des Nießbrauchs, so wird der Nießbraucher Eigentümer der Sachen, nach der Beendigung des Nießbrauchs hat er dem Besteller den Wert zu ersetzen, den die Sachen zur Zeit der Bestellung hatten. Sowohl der Besteller als der Nießbraucher kann den Wert auf seine Kosten durch Sachverständige feststellen lassen. 2 Der Besteller kann Sicherheitsleistung verlangen, wenn der Anspruch auf Ersatz des Wertes gefährdet ist.'

The draughtsmen of the GCC have extensively elaborated upon the theoretical background of the irregular right of usufruct. The German legislator makes a distinction between assets that are fit for use or that produce fruits, and other assets. In respect of the first category of assets, a regular right of usufruct can be established. The second category, in any case, comprises assets that derive their value from the fact that they can be consumed or can be disposed of (consumable assets). In principle, such assets cannot be subject to a regular right of usufruct, but only to an irregular right of usufruct. An irregular right of usufruct entails a passing of ownership. In this case, the usufructuary is under an obligation to compensate the original owner for the value of the assets upon termination of the right of usufruct. The original owner can request a security to ensure that this obligation will be fulfilled.¹⁵⁷

c. *Old Dutch law*

Under old Dutch law, the right of usufruct in respect of consumable assets was regulated in Article 804 of the Civil Code. The text of this provision is as follows:

If, however, the right of usufruct relates to consumable assets, the usufructuary can, upon the termination of the right of usufruct, confine itself to returning an equivalent quantity, quality and value, or to paying the price at which the assets have been estimated at the start of the right of usufruct, or shall be estimated according to the value at that moment.¹⁵⁸

Under old Dutch law, as in German law, ownership passed in the case of the establishment of an irregular right of usufruct. In the case an irregular right of usufruct was vested, the original owner lost his title and was left with a contractual right against the new owner. In order to enhance the enforceability of this contractual right, a security interest was sometimes established.¹⁵⁹

157 See the Drafters of the GCC, p. 253 *et seq.* See, in the same sense, the definitions of 'usufruct' and 'quasi-usufruct' in Black's Law Dictionary (including references to Roman law). On the moment at which ownership passes, and to whom, see sections 4.6.4 and 4.6.5 below.

158 See Fruin 1990. Translation: TK. Original Dutch text: 'Indien echter onder het vruchtgebruik verbruikbare zaken zijn begrepen, kan de vruchtgebruiker volstaan met, bij het eindigen van het vruchtgebruik, eene gelijke hoeveelheid, hoedanigheid en waarde terug te geven, of den prijs te betalen, op welken de zaken bij aanvang des vruchtgebruiks mogten geschat zijn, of volgens de waarde van dat tijdstip mogten geschat worden.'

159 See Van Gaalen 2001, no. 022.

d. *Current Dutch law*

Widening of the rights of the usufructuary

In the course of the revision of the Dutch Civil Code, the legislator has widened the rights of the usufructuary considerably. Under current Dutch law, the rights of a usufructuary are not necessarily confined to using an asset or to enjoying the fruits thereof. In Articles 3:207, 212-213 and 215 of the NCC, which are discussed in further detail below, the legislator has conferred a number of extra rights upon the usufructuary, such as the rights to consume, dispose of or spend encumbered assets. The intention of the legislator has probably been to make the right of usufruct a flexible instrument, which makes it possible to make maximum use of the economic value of assets.¹⁶⁰

One example of the widening of the rights of the usufructuary can be found in section 1 of Article 3:207 of the NCC. This provision not only makes it possible that the usufructuary uses, but also that he consumes assets. The text of this provision is:

The usufructuary may use or consume property subject to the usufruct according to the rules made at the time of establishment of the usufruct or, in their absence, with due regard to the nature of the property and local usage governing use or consumption.¹⁶¹

Consumption here means that the assets are used up and are no longer available. If and how the usufructuary compensates the original owner must be established on the basis of the contract between the parties or, in its absence, in line with the nature of the property involved and local usage.¹⁶²

The rights of the usufructuary are also extended in relation to property that is intended to be alienated, such as securities. On the basis of section 1 of Article 3:212 of the NCC, the usufructuary has the right to dispose of such property in his own name in conformity with its destination. This

160 See Meijers' Explanatory Notes to Title 3.8 of the NCC, in particular the introductory remarks. See also Groefsema, 1993, pp. 156-157.

161 Translation: Netherlands Business Legislation. Original Dutch text: 'Een vruchtgebruiker mag de aan het vruchtgebruik onderworpen goederen gebruiken of verbruiken overeenkomstig de bij de vestiging van het vruchtgebruik gestelde regels of, bij gebreke van zodanige regels, met inachtneming van de aard van de goederen en de ten aanzien van het gebruik of verbruik bestaande plaatselijke gewoonten.'

162 See Meijers' Explanatory Notes to Title 3.8 of the NCC, Article 3.8.1 and Article 3:8.6.

right follows directly from the law. According to sections two and three of Article 3:212, the right to dispose can also be granted to the usufructuary by the original owner or by the subdistrict court (*kantongerecht*) in respect of other assets. The text of Article 3:212 of the NCC is as follows:

1. To the extent that property subject to a usufruct is intended to be alienated, the usufructuary is entitled to alienate it in conformity with its destination.
2. At the time of establishment of the usufruct, the usufructuary may also be given the power to dispose of property other than that mentioned in the preceding paragraph. [...]
3. In other cases the usufructuary may not alienate or encumber property without the consent of the holder of the principal right or the authorisation of the subdistrict court. [...] ¹⁶³

If the usufructuary indeed disposes of the encumbered assets in line with Article 3:212 of the NCC, proprietary substitution takes place. This means that the original owner becomes the owner of the replacement goods, while the usufructuary obtains a right of usufruct in respect of those replacement goods. The rule of proprietary substitution is set out in Article 3:213 of the NCC. Section 1 of this provision reads as follows:

Property taking the place of property subject to the usufruct and duly disposed of, belongs to the holder of the principal right and is also subject to the usufruct. The same applies to receipts from the collection of claims subject to the usufruct and to claims for compensation which take the place of property subject to the usufruct, including claims resulting from a reduction in value of that property. ^{164 165}

163 Translation: Netherlands Business Legislation. Original Dutch text: '1. Voor zover de aan een vruchtgebruik onderworpen goederen bestemd zijn om vervreemd te worden, is de vruchtgebruiker tot vervreemding overeenkomstig hun bestemming bevoegd. 2. Bij de vestiging van het vruchtgebruik kan aan de vruchtgebruiker de bevoegdheid worden gegeven ook over andere dan de in het vorige lid genoemde goederen te beschikken. [...] 3. In andere gevallen mag een vruchtgebruiker slechts vervreemden of bezwaren met toestemming van de hoofdgerechtigde of machtiging van de kantonrechter. [...]'.

164 Translation: Netherlands Business Legislation. Original Dutch text: 'Hetgeen in de plaats van aan vruchtgebruik onderworpen goederen treedt doordat daarover bevoegdelijk wordt beschikt, behoort aan de hoofdgerechtigde toe en is eveneens aan het vruchtgebruik onderworpen. Hetzelfde is het geval met hetgeen door inning van aan vruchtgebruik onderworpen vorderingen wordt ontvangen, en met vorderingen tot vergoeding die in de plaats van aan vruchtgebruik onderworpen goederen treden, waaronder begrepen vorderingen ter zake van waardevermindering van die goederen.'

165 In relation to Articles 3:212 and 213 of the NCC see Meijers' Explanatory Notes to Title 3.8 of the NCC, in particular to Articles 3.8.1, 3.8.10 and 3.8.11.

A third example of the widened rights of the usufructuary under the current Dutch Civil Code can be found in Article 3:215 of the NCC. On the basis of this provision, a usufructuary can be granted the right to 'alienate or spend' the property subject to the right of usufruct. The text of section 1 of Article 3:215 of the NCC is as follows:

Where the usufructuary is entitled to alienate or spend¹⁶⁶, wholly or partially, the property subject to the usufruct, the holder of the principal right can, upon the termination of the usufruct, claim the surrender of the property granted in usufruct or that which has taken its place, to the extent that the usufructuary or his assignees do not establish that the property has been spent or has perished by fortuitous event¹⁶⁷

This provision can best be understood from the point of view of the law of inheritance. The Dutch legislator originally considered the right of usufruct one of several possible ways to regulate the relationship between the longest living spouse and the family of the deceased person (in the absence of a last will). With Article 3:215 of the NCC, the legislator pursued two goals. On the one hand, the legislator wanted to take the maintenance needs of the longest living spouse into account. On the other, he wanted to honour the ownership claims of the family of the deceased person. The legislator was convinced that the right of usufruct would only be suitable for these goals if it were possible for the longest living spouse to dispose of the assets subject to the right of usufruct and to use them up, without incurring an obligation to replace them or their value at a later date. In order to honour the ownership claims of the family of the deceased as well, the theory relating to the irregular right of usufruct (which would have implied a passing of ownership to the longest living spouse) had to be set aside.¹⁶⁸

166 Note of the translators This institution resembles the *fideicommissum de residuo*. The term "to spend" ("*verteren*") must be distinguished from the term "to consume" ("*verbruiken*") in article 207 of Book 3. "To spend" here means that the usufructuary may touch capital without incurring the obligation to replace it at a later time.

167 Translation Netherlands Business Legislation. Original Dutch text: 'Is bij de vestiging van een vruchtgebruik of daarna aan de vruchtgebruiker de bevoegdheid gegeven tot gehele of gedeeltelijke vervreemding en vertering van aan het vruchtgebruik onderworpen goederen, dan kan de hoofdgerechtigde bij het einde van het vruchtgebruik afgifte vorderen van de in vruchtgebruik gegeven goederen of hetgeen daarvoor in de plaats getreden is, voor zover de vruchtgebruiker of zijn rechtverkrigenden niet bewijzen dat die goederen verteerd of door toeval tenietgegaan zijn.'

168 See Meijers' Explanatory Notes, Article 3:8-13, Van Gaalen 2001, chapters 1 and 2, Florijn 1994, chapter 6.

However, in the new law of inheritance in Book 4 of the NCC, which came into force in 2003 (a number of years after the introduction of the NCC's general provisions on the right of usufruct in 1992), the right of usufruct plays a limited role only. In Book 4, the relationship between the longest living spouse and the family of the deceased has been regulated in a different manner. In principle, the longest living spouse inherits everything, whereas the children are given a contractual claim against the longest living spouse that is enforceable only upon the latter person's insolvency or death.¹⁶⁹ The adapted rules on usufruct have only been applied in Articles 4:19, 4:21, 4:29 and 4:30 of the NCC.^{170 171}

Drawbacks

It appears from the above that under current Dutch law, the scope of the original right of usufruct, i.e. the right to enjoy the fruits and/or the use of an asset, has been widened considerably. Under the current Dutch Civil Code, a usufructuary can have the right to consume, dispose of or spend the assets encumbered with a right of usufruct. In principle, the right of ownership does not pass to the usufructuary if a right of usufruct is combined with a general right of disposal. As such, the Dutch legislator has deviated from the rule on the irregular right of usufruct that had, until then, been in force, and thus from the theory on consumable goods as outlined in section 4.6.2 above. The adapted rules, however, have led to complications from the perspective of general property law.

In legal literature, particularly the rule on proprietary substitution of Article 3:213 of the NCC is subject to critique. Van Gaalen notes friction when a usufructuary obtains registered claims (*vorderingen op naam*) or registered (immovable) property (*registergoederen*). It is not clear how the circumstance that these assets are registered to the name of the usu-

169 See Title 4.3 of the NCC.

170 See Van Mourik 2002.

171 Likewise, under German law the relationship between the longest living spouse and the family of the deceased has not been addressed by envisaging a right of disposal for a usufructuary. It follows from §§ 1085-1089 of the GCC (*Niessbrauch an einem Vermögen*) that a right of usufruct in respect of consumable assets that form part of a patrimony (*Vermögen*) or of the estate of a deceased person, leads to a passing of ownership. In Germany the theory on the irregular right of usufruct has been maintained unimpaired (see also subsection b on German law above). In order to solve the issue arising under the law of inheritance, German law envisages special rules concerning the *Vorerbschaft* and the *Nacherbschaft* (see §§ 2100-2146 of the GCC). These rules make it possible to leave an inheritance to the longest living spouse until his or her death, after which it falls to the family of the deceased person.

fructuary should be matched with an ownership claim of someone else that is based on the rule of proprietary substitution.¹⁷² In addition, Meijers and Hammerstein remark that the rule of proprietary substitution does not always offer real certainty, because it may be difficult for the original owner to prove to which assets exactly he is entitled. This may be difficult, for example, when the usufructuary has become the owner on the basis of (unauthorized) commingling. Particularly in the case of consumable assets, which often are not easily identifiable, it may, in practice, be difficult for the original owner to prove to which assets his proprietary interest attaches.¹⁷³ Both on a theoretical and a practical level, a usufructuary's general right of disposal therefore leads to complications. Van Gaalen concludes that the old system that recognised an irregular right of usufruct (a transfer of ownership, if necessary combined with a security interest) functions best.¹⁷⁴

No validity for right of pledge

Even if one is in favour of a usufructuary's general right of disposal, despite the theoretical and practical problems arising from it, this does not necessarily mean that the same concept should also be applied in the case of the right of pledge. The relationship between an owner and a usufructuary is essentially different from that between an owner and a pledgee. In the latter relationship, the credit provider/pledgee is often in a more powerful position than the pledgor/owner. It is precisely this imbalance that makes it undesirable to give the party who is in the stronger position, i.e. the pledgee, a general right of disposal in respect of assets provided as security, and, in doing so, the possibility of ending the fiduciary relationship between the parties altogether.

e. Conclusion

Under the old Dutch Civil Code, the rights of a usufructuary were limited to using and enjoying the fruits of an asset. A right of usufruct in respect of consumable assets was characterised as irregular, and led to a passing of ownership. Under the current Dutch Civil Code, this approach is abandoned. The rights of a usufructuary are widened, as he may under certain circumstances consume, dispose of or spend the encumbered goods. Under current Dutch law, a usufructuary's right of disposal in

172 See Van Gaalen 2001, sections 5.4 and 5.5 and, on the same issue, Asser Series 2-I, nos. 128-134; Asser Series 3-I, nos. 216-217 and no. 253.

173 See Meijers' Explanatory Notes, Article 3.8.9; and Hammerstein 1977, p. 161.

174 See Van Gaalen 2001, section 5.8 and chapter 7 (in particular number 175).

principle does not lead to a passing of ownership. In taking this new approach, the Dutch legislator wanted to enhance a flexible use of encumbered assets. In addition, the amended right of usufruct was originally intended as a way to regulate the position of the longest living spouse and the family of the deceased under the law of inheritance. This latter problem has, however, in the meantime been addressed by envisaging a solution specific to the law of inheritance. Moreover, the construction of a right of usufruct combined with a general right to use up or dispose is unfortunate from a theoretical point of view. It is not compatible with the general principle of civil law – that making assets replaceable leads to a passing of ownership. It also leads to practical problems in relation to registered claims and registered immovable property, and because of possible commingling, for example.

German law maintains a traditional approach, which certainly has its merits. The right of *usufruct* entails a right to enjoy the *use* or the *fruits* of an asset. Dispositions in respect of such an asset are not compatible with the limited nature of a right of usufruct. In this case, one should speak of an irregular right of usufruct, which entails a transfer of ownership. In order to regulate the relationship between the longest living spouse and the family of the deceased, the law of inheritance envisages the special rules of *Vorerbschaft* and *Nacherbschaft*.

In any case, the Dutch regulation on the right of usufruct cannot be used as a blueprint for the introduction of the right of use of the Collateral Directive in Dutch or German law. The right of pledge, unlike the right of usufruct, often goes hand in hand with a level of inequality between the owner and the party with the limited right. It is undesirable to give the usually more powerful party, the pledgee, a general right of disposal, and thus the right to end the fiduciary relationship between the parties.

4.6.4 *The moment that ownership passes: residual rights for the original owner?*

a. Introduction

This section attempts to determine the moment at which a collateral provider loses his ownership interest. Does this happen at the moment that the security interest combined with a general right of disposal is vested, or at the moment that the right of disposal is exercised by the collateral taker? It also examines the rights of the original owner in the time frame between granting a secured party a general right of disposal and the

exercise of that right. This section shows that the Collateral Directive's right of use, if one interprets it by applying the theory on irregular structures, leads to pressure on the Dutch and German systems of property law and entails a worsening of the position of collateral providers.¹⁷⁵

b. Theoretical considerations

It is usually argued by Dutch legal scholars that ownership passes at the moment the parties establish an irregular right of pledge or usufruct, or an irregular custody arrangement.¹⁷⁶ This is also the starting point in respect of the irregular pledge under German law¹⁷⁷, and in respect of irregular custody and right of usufruct arrangements (codified in § 700 and § 1067 of the German Civil Code respectively)¹⁷⁸. Likewise, a loan of fungibles entails a passing of ownership at the moment the loan is entered into.¹⁷⁹ If there is no other agreement between the parties on this issue, the fact that one makes assets replaceable automatically makes ownership pass.¹⁸⁰

However, it has also been argued that it is possible to deviate from this principal rule. In the context of an irregular right of pledge, for example, Houwing stresses the importance of the relationship between the parties.¹⁸¹ The Staudinger Commentary, too, takes the moment an irregular right of pledge is entered into as a starting point, but stresses the will of the parties as an important factor.¹⁸² Additionally, in the case of a loan of fungibles, an irregular custody arrangement and an irregular right of usufruct, the parties can, under German, law deviate from the principal rule and agree upon a passing of ownership at the moment the assets concerned are actually disposed of by the original owner's counterparty.¹⁸³

175 See, in particular, section 4.5.5 above on comparable consequences that arise when one applies the theory relating to a non-owner's general right of disposal.

176 In this sense, see Meijer 1974, p. 27 (section 4); Hammerstein 1977, chapter IV, § 2.

177 See the Staudinger Commentary, (Neubearbeitung 2002), § 1204, no. 54, which takes the moment the irregular arrangement is entered into as a starting point.

178 See the Palandt Commentary, 64th edition, § 700 and § 1067.

179 See section 2.4.2 of chapter III.

180 Under Danish and Italian law ownership also passes at the moment an irregular structure is agreed upon. See chapters 1 and 4 of the Right of Use Report.

181 See Houwing 1952, pp. 170-171.

182 See the Staudinger Commentary, Neubearbeitung 2002), § 1204, no. 54.

183 See Palandt Commentary, 64th edition, § 607, sections 2 and 6 (loan of fungibles); Palandt Commentary, 64th edition, § 700 (irregular custody); Palandt Commentary, 64th edition, § 1067; Munich Commentary, Volume 6 *Sachenrecht* (§§ 854-1296), third edition, § 1067, in particular section 9 (irregular right of usufruct).

c. *The Collateral Directive*

Article 5 of the Collateral Directive does not follow the principal rule that ownership passes at the moment that consumable assets are made replaceable. It presumes that the collateral provider is the owner and that the collateral taker only has a security interest until the moment that the collateral taker disposes of the encumbered assets, at which time a third party acquires ownership.¹⁸⁴ Thus, the Collateral Directive is in keeping with the approach that the parties who establish an irregular right of pledge can agree that ownership passes at the moment of actual disposal. It should, however, be noted that this approach has a number of drawbacks, which are outlined below.

d. *'Weak' ownership and redemption rights*

A first peculiarity has already been indicated in the sections on American and English law and relates to the 'weak' character of the residual rights of the collateral provider in the period until the collateral taker exercises his right. Not only are his ownership and redemption rights subject to his own default, but they can also be cancelled out the moment the collateral taker decides to exercise his right of disposal. In fact, this leads to a security interest of a special kind, in which the collateral taker – in practice often the stronger party – has the power to end the fiduciary relationship between the parties.¹⁸⁵

e. *A continued right of disposal?*

A further complication not yet investigated, relates to the original owner's right of disposal. The approach that stresses the autonomy of the parties and that allows a passing of ownership at the moment of actual disposal gives rise to further questions in this respect. Does the original owner, in the period between the establishment of the right of use and the actual exercise thereof, have the power to establish more security interests (either combined with a general right of disposal or not), or to transfer the encumbered property to a third party? Or, does his right to dispose of the encumbered property terminate at the moment the first security interest combined with a right of disposal is established?

184 See, in the same sense, Article 7:53(2) of the NCC.

185 On American and English law see sections 2.4.4 ('Residual rights?') and 3.4.4 ('Residual rights?') above.

Arguably, the power of the original owner to establish further security interests (either combined with a right of disposal or not), or to transfer the assets concerned to a third party, is still in place. An owner has the right to dispose of his assets. The presumption of the original owner's continued right of disposal, however, again shows how weak the original owner's remaining interest is. What has the original owner left to dispose of? His ownership interest is seriously impaired. If the first secured party exercises his right of use, the original owner's interest is wiped out entirely. The original owner can therefore only dispose of a right that is subject to the condition that the first secured party does not invoke his right of use. In addition, the original owner can dispose of the contractual claim for the transfer of equivalent assets, which may arise in future after the first secured party has indeed exercised his right of use. Arguably, a subsequent secured party or transferee can therefore obtain nothing more from the original owner than an interest in assets that is subject to the first secured party's right of disposal, or a contractual claim relating to equivalent assets that may arise in future.

An alternative solution would be to prohibit the original owner from disposing of assets any further once he has encumbered them with a security interest combined with a right of use. Such a complete termination of the owner's right of disposal, however, is hardly compatible with the unlimited nature of an ownership right.¹⁸⁶ Still, the attractive side of this solution is that it provides clarity. It also illustrates how little has remained of the original owner's proprietary interest.¹⁸⁷

f. Concluding remark

The above shows that the approach whereby ownership can pass at a later moment than that at which the irregular right of pledge is vested, i.e. at the moment that the right of disposal is exercised, leads to tensions in the system of property law. Already during the interim period between vesting the right of pledge and actual disposal, the proprietary interest of the original owner is seriously impaired. His ownership and redemption rights are not strong because they can be terminated by the collateral taker at any moment in time. As a result, the original owner has hardly

186 Comparable objections can be made in respect of the exclusive mandate (*exclusieve last*) in Dutch law, which is set out in Article 7:423 of the NCC. On this latter issue see Asser Series 5-III, in particular section 169.

187 Suggested as a possible solution by Van Hees in Lieveise / Wiggers-Rust 2005, pp. 61-62.

anything left to dispose of for the benefit of a subsequent third party pledgee or transferee. He can merely dispose of an ownership right that is subject to the first pledgee's general right of disposal, and of a contractual claim for the delivery of equivalent assets that may arise in future. The suggestion that full ownership continues until the actual moment of disposal is therefore deceptive. Only a vague reflection thereof is actually still in place. The position of the collateral taker is the mirror image of that of the collateral provider. The collateral taker does not merely have a security interest. His right to dispose of the encumbered assets makes his position very much akin to that of an owner. A similar blurring of the ownership concept does not occur in connection with the principal rule that ownership passes at the moment that assets are made replaceable.

4.6.5 *To whom does ownership pass?*

A related question that deserves at least a few words, is whether ownership passes through the patrimony (*vermogen*, *Vermögen*) of the collateral taker who exercises a general right of disposal before falling to the third party acquirer, or whether it falls directly to the third party.

In irregular structures, ownership in principle passes from the original owner to the 'pledgee', 'usufructuary' or 'custodian' at the moment the irregular structure is entered into. Only after a subsequent disposal by the original owner's counterparty to a third party acquirer, do the assets concerned fall to that third party.

However, if the original owner and his counterparty have agreed that ownership does not pass at the outset of the transaction, but at the later moment of disposal by the counterparty, two approaches are available. The first is an indirect approach, in which ownership passes through the patrimony of the original owner's counterparty for a split second and subsequently falls to the third party. In the second, or direct approach, ownership does not pass through the patrimony of the original owner's counterparty, but falls directly to the third party acquirer.¹⁸⁸

A parallel can be drawn with a reservation of title arrangement. As was indicated in section 4.5.1, Dutch legal theory has broadly developed two legal theories to explain the passing of ownership to a third party acquirer

188 On these two principal approaches and the variations thereof in Dutch legal theory, see Asser Series 2-I, sections 135-136.

upon disposal by a buyer under a reservation of title arrangement. These theories broadly coincide with the direct and the indirect approaches indicated above. If the buyer's power of disposal is based on the occurrence of a condition precedent (that of a disposal in the normal course of business), the buyer disposes as a full owner, and the assets pass through him. If, however, the buyer's power of disposal is based on a contractually granted non-owner's right of disposal (*machtiging*), ownership passes directly to the third party acquirer. Likewise, under a German reservation of title arrangement, a buyer's right of disposal can be based on a condition precedent, in which case ownership passes through the buyer before it falls to the third party acquirer. Under German law, a reservation of title arrangement is, however, commonly combined with the buyer's right of disposal on the basis of § 185 of the GCC. In this case, ownership passes directly from the original owner to the third party acquirer, without assets passing through the first buyer.¹⁸⁹

The Collateral Directive is silent on the issue. It is therefore possible to argue that the Collateral Directive should, in this respect, be interpreted in accordance with the theory on the irregular structures, which means that ownership passes through the collateral taker. It is, however, also possible to deviate from the principal rule of the irregular structures (as with the timing issue; see section 4.6.4 above), and to follow the approach that title passes directly from the collateral provider to the third party and does not pass through the collateral taker.

4.7 Proprietary substitution

4.7.1 Introduction

This section discusses the rule of proprietary substitution set out in Article 5(3) of the Collateral Directive. It examines the practical effects of the Collateral Directive's rule of proprietary substitution on the positions of collateral provider and collateral taker. This section also explores whether the rule set out in the Collateral Directive is compatible with Dutch property law. In addition, it investigates whether there are alternatives to the Collateral Directive's rule of substitution.

189 See also sections 4.5.1, including references to literature, and 4.5.3 above.

4.7.2 Article 5 of the Collateral Directive

Apart from the introduction of a general right of disposal for a secured party (which can only be accommodated in a satisfactory way by referring to the irregular right of pledge), the Collateral Directive also sets out a rule of proprietary substitution in Article 5(3). The directive deviates at this point from the irregular right of pledge, which contains no rule of proprietary substitution. The Collateral Directive's rule of proprietary substitution is structured as follows. If the collateral taker exercises his right of use, the collateral provider is left with a contractual claim until the moment that the collateral taker transfers equivalent assets to the collateral provider. These assets must be transferred at the end of the transaction at the latest. As soon as these equivalent assets are transferred, the Collateral Directive's rule of proprietary substitution takes effect. This means that the original proprietary structure now relates to the equivalent assets. Consequently, the collateral provider has an ownership interest in the equivalent assets and the collateral taker a security interest therein. These interests are backdated. The substitute financial collateral is treated as if it had been provided the moment the original collateral was first provided.

4.7.3 Practical effects?

As was argued in the sections above, the Collateral Directive's right of use means that for a collateral provider, proprietary interest in respect of collateral is replaced by a contractual claim against the collateral taker, in any case from the moment the collateral taker transfers the collateral assets to a third party. At first sight, a rule of proprietary substitution may seem to mitigate this negative consequence of the right of use for the collateral provider. It should, however, be noted that the Collateral Directive's rule does not relate to all kinds of replacement assets (i.e. notably the proceeds from a transfer of the original collateral to a third party), and also does not relate to equivalent assets that form or will form part of the patrimony of the collateral taker. The substitution rule of the directive relates to equivalent assets only after they have been transferred by the collateral taker, usually at the end of the transaction. The same is true for Article 7:53(4) of the NCC. In the course of parliamentary history, the Dutch Minister of Justice has remarked that proprietary substitution takes place only upon a transfer of the equivalent assets by the collateral

taker.¹⁹⁰ The collateral provider is therefore still faced with a contractual claim from the moment that the collateral taker exercises his right of use to the moment that the collateral taker decides to transfer equivalent collateral. The Collateral Directive's rule of proprietary substitution is of little use to the collateral provider in this respect.

Arguably, the Collateral Directive's rule of proprietary substitution has advantages only for the collateral taker. The directive envisages a continued security interest for his benefit even after the transfer of equivalent assets. This interest is backdated to the start of the transaction, and can therefore not be surpassed by, for example, an attachment or a right of pledge relating to the assets of the collateral provider that has been vested after that moment.

From a practical point of view, however, the Collateral Directive's rule of proprietary substitution may not have any value at all. In practice, it is usually agreed by the parties that a collateral taker is not obliged to transfer equivalent assets unless the collateral provider fulfils the secured debt at the same time. In order to minimize risk, the collateral taker will therefore only transfer equivalent collateral at the end of a transaction, when the collateral provider fulfils the secured debt. What is the use of proprietary substitution at this moment? With the fulfilment of the secured debt, the collateral taker's security interest is customarily no longer available in line with its accessory nature, which renders proprietary substitution at this moment useless.

4.7.4 *Compatibility with Dutch property law?*

The rule of proprietary substitution set out in the Collateral Directive, which envisages substitution by equivalent assets upon a transfer by the collateral taker, deviates from traditional rules of proprietary substitution under Dutch law. Under Dutch law, substitution customarily takes place immediately and relates to all kinds of replacement assets. In parliamentary history of implementing the Collateral Directive in Dutch law, the Minister of Justice has noted that the Collateral Directive's rule of substitution has much in common with four already available rules of proprietary substitution. While this may be true, the minister has ignored the fundamental difference between immediate substitution by all kinds

190 See sections 9 and 18 of the Additional Explanatory Memorandum (*Nadere Memorie van Antwoord*), *Eerste Kamer*, 2004-2005, 28 874, E.

of replacement assets and substitution at a later moment in time by equivalent assets only. The four rules mentioned by the Dutch Minister of Justice will be examined in greater detail below.¹⁹¹

The first rule of proprietary substitution to which the minister compares the Collateral Directive's rule of substitution is that of Article 3:213 of the NCC. This rule was already discussed in section 4.6.3 above and relates to substitution upon disposal by a usufructuary. One of the fundamental characteristics of this rule of proprietary substitution is that it takes place immediately and applies to all kinds of replacement assets. This is not the case under Article 5(3) of the Collateral Directive, in which substitution is limited to equivalent assets, which are usually made available at a later date only.

The second rule of proprietary substitution to which the rule of the Collateral Directive is compared is that found in Article 3:229 of the NCC. This rule was already discussed in section 4.4 above. The rule of proprietary substitution in Article 3:229 of the NCC primarily relates to damages or insurance money due if a pledged asset is damaged or destroyed. According to this rule proprietary substitution takes place right away and relates to any substitute assets.¹⁹²

The minister also mentions two other rules of proprietary substitution, which are set out in Articles 3:167 and 3:246(5) of the NCC respectively. Article 3:167 of the NCC relates to goods of a community (*gemeenschap*) that are replaced by other goods. Article 3:246(5) concerns the collection of a pledged claim, in which the right of pledge attaches to the proceeds. Again, proprietary substitution in these instances takes place immediately, and relates to any goods replacing the original ones.¹⁹³

The above considerations make clear that the rule of proprietary substitution set out in the Collateral Directive differs fundamentally from proprietary substitution as it is traditionally known under Dutch law. Under the traditional rules, proprietary substitution takes place *imme-*

191 See sections 9 and 18 of the Additional Explanatory Memorandum (*Nadere Memorie van Antwoord*), *Eerste Kamer*, 2004-2005, 28 874, E

192 The German doctrine on perishable goods was also discussed in section 4.4. If a pledgee disposes of such goods, these goods are substituted by the proceeds of this disposal. This rule of proprietary substitution also takes effect immediately.

193 On Article 3:167 of the NCC, see the Parliamentary History of the NCC, *Boek 3, Vermogensrecht in het algemeen*, p. 580. On Article 3:246 of the NCC, see the Parliamentary History of the NCC, *Boek 3, Vermogensrecht in het algemeen*, pp. 771-774.

diately and automatically in relation to all kinds of replacement assets, whereas under the Collateral Directive, substitution takes place only upon a transfer by the collateral taker, usually at the end of a transaction and only in relation to equivalent assets. This means – and this is crucial – that under the the Collateral Directive a collateral provider is left with a mere contractual claim from the moment the collateral taker disposes of the original assets until the moment that the collateral taker decides to transfer equivalent assets. During this time frame, the collateral provider runs an insolvency risk in respect of the collateral taker.

It is perhaps worthwhile to note that under Dutch law, proprietary substitution is allowed only in a limited number of cases. The main reason for this is probably that after substitution the security provider is faced with the possibility that he may now have an interest in assets entirely different from the ones he originally owned. Ideally, the original assets are returned to the security provider upon termination of the relationship between the parties. Only in exceptional circumstances that are beyond the control of the parties (such as a fire or a thunderstorm that gives rise to an insurance claim), is a deviation from this rule considered acceptable. Reehuis therefore argues that in Dutch law there is no room for proprietary substitution if a collateral taker transfers assets to a third party with the consent of the collateral provider. The Collateral Directive clearly deviates from this position.¹⁹⁴

4.7.5 Alternatives?

One final consideration is whether there are alternatives for the Collateral Directive's rule of proprietary substitution, which relates to equivalent assets upon a transfer by the collateral taker. Could proprietary substitution, for example, relate to equivalent assets as soon as the collateral taker becomes entitled to them, or to all kinds of replacement assets, such as sale proceeds, etc.? What are the advantages of such alternatives?

By accepting that proprietary substitution takes place at the moment that equivalent assets become part of the patrimony of the collateral taker, the interests of the collateral provider are better taken into account because, in effect, this approach entails a possible limitation of the period in which the collateral provider is left with a contractual claim. Another advantage of this approach is that these equivalent assets cannot, for example, be

194 See Pitlo / Reehuis, Heisterkamp 2001, section 756.

encumbered with a right of pledge that prevails over the interests of the original collateral provider for the benefit of a third party, and cannot be subject to an attachment (*beslag*) by third parties to the detriment of the collateral provider.

The same *a fortiori* holds true for a rule of substitution based on the replacement of original assets by other assets. In this case, there is no time period at all in which the collateral provider has a contractual claim only. Moreover, there is no risk that third parties establish rights (e.g. a right of pledge or an attachment) that prevail over those of the collateral provider. Apart from that, this latter rule relating to replacement assets would be most compatible with the rules of Dutch law in relation to proprietary substitution outlined above. However, when substitution relates to all kinds of replacement assets, there may be a complicating factor – one that does not arise when substitution relates to equivalent assets as soon as they become part of the collateral taker's patrimony. It becomes complicated, when assets are transferred through chains of intermediaries, including clearing houses, in which netting arrangements are in place, as it may in such cases prove impossible to determine exactly which assets can be identified as replacement. Because identification is crucial, proprietary substitution arguably cannot take place in such cases.¹⁹⁵

All in all, the current Collateral Directive's rule of proprietary substitution is an empty shell, which, in practice, offers the collateral provider no protection whatsoever. Therefore it is submitted that, contrary to the approach taken in the Collateral Directive, it is desirable that proprietary substitution should take place at the moment equivalent assets become part of the patrimony of the collateral taker, while an even more desirable improvement would be if substitution, in as far as is practically possible, could relate to all kinds of replacement assets.

4.8 Implementation in Germany and the Netherlands

The German legislator has taken the correct approach in implementing a security interest combined with a right of use, by referring to the doctrine on the irregular right of pledge. Because the irregular right of pledge is recognised under German law, the German legislator has not introduced

195 On the issue of the identification of proceeds, see also sections 1.3.3 ('A right of use in Europe – Why?'); 2.4.5 ('No interest in the proceeds'); and 3.4.5 ('An interest in proceeds or equivalent assets?').

an explicit legal provision in order to implement the Collateral Directive's right of use. There is, however, at least one thing missing: the German legislator has not considered the Collateral Directive's remarkable rule of proprietary substitution.¹⁹⁶

It would, in my view, have been logical if the Dutch legislator would have implemented the right of use by referring to the doctrine on the irregular right of pledge also. The Dutch legislator, however, has paid hardly any attention to the way a pledgee's general right of disposal should be interpreted from a theoretical point of view. Article 7:53 of the NCC simply gives the collateral taker a right to 'use or sell'¹⁹⁷ without further explanation, and, in line with the Collateral Directive, sets out a rule of proprietary substitution, which should take place before the end of a transaction. According to the Dutch legislator, a security interest combined with a general right of disposal is 'something in between' an outright transfer and a right of pledge.¹⁹⁸ No attention has been paid to the theoretical foundation of the pledgee's general right of disposal.¹⁹⁹

The unprecedented way in which a security interest combined with a general right of disposal harms the position of providers of security and favours that of security takers, and the fact that the Collateral Directive's

196 See the *Diskussionsentwurf des Bundesministeriums der Justiz, Entwurf eines Gesetzes zur Änderung der Insolvenzverordnung, des Bürgerlichen Gesetzbuches und anderer Gesetze*, pp 18-19, *Gesetzentwurf der Bundesregierung, Entwurf eines Gesetzes zur Umsetzung der Richtlinie 2002/47/EG vom 6 Juni 2002 über Finanzsicherheiten und zur Änderung des Hypothekendarlehenbankgesetzes und anderer Gesetze*, Bundesrat, Drucksache 563/03, 15 August 2003, p 13, *Gesetzentwurf der Bundesregierung, Entwurf eines Gesetzes zur Umsetzung der Richtlinie 2002/47/EG vom 6 Juni 2002 über Finanzsicherheiten und zur Änderung des Hypothekendarlehenbankgesetzes und anderer Gesetze*, Deutscher Bundestag, Drucksache 15/1853, 29 October 2003, pp 27-28 (in particular section 6a) and p 32 (in particular section 6a) See, on the same issue, Lober 2005, pp 75-76, and the *Auslegung des Bundesministeriums der Finanzen zur Thematik Primebroker nach dem Investmentgesetz (Stand 26 Mai 2004)*, mentioned in footnote 23 of Lober 2005 and available on www.bafin.de (through the links *Für Anbieter*, *Inländische Investmentfonds*)

197 This terminology is not correct. The Dutch legislator should have used the term 'dispose'

198 See the Dutch Additional Explanatory Memorandum (*Nadere Memorie van Antwoord*), *Eerste Kamer*, 2004-2005, 28 874, E, section 22, pp 21-22

199 See, in particular, the Explanatory Comments (*Memorie van Toelichting*) in respect of Article 7:53 of the NCC in *Tweede Kamer*, 2002-2003, 28 874, no 3, pp 6-7 and pp 15-16, and in *Tweede Kamer*, 2004-2005, 30 138, no 3, pp 7-8 and pp 16-17. For a more detailed discussion of the problematic approach of the Dutch legislator in respect of the Collateral Directive's rule of proprietary substitution, see section 4.7 above.

rule of proprietary substitution is, in reality, usually an empty shell that provides no protection to collateral providers whatsoever, have not been given sufficient attention. Nor has the scope of application of the right of use been sufficiently considered, which can also be applied in bank/customer and in custodian/client relationships (excluding private persons), possibly even on the basis of generally applicable conditions. The possible negative consequences of the Collateral Directive's right of use have, therefore, not been taken into consideration. Dutch and German legislators have only stressed the positive effects of a right of use for the liquidity of the cash and securities markets.

A key issue of interpretation in the Collateral Directive (and the national implementing legislation) is the scope of the term 'financial collateral arrangement'. Should these arrangements, under all circumstances, fulfil the two functions of recovery and tradeability, or does the Collateral Directive also relate to arrangements that serve a recovery function only? Specifically in the case of a security interest (such as a right of pledge), the question is whether the scope of the Collateral Directive should be limited to security interests combined with a right of use, or expanded to include also traditional security interests without a general right of disposal. This issue is further discussed in chapter VI.

4.9 Concluding remarks

On the basis of the 'right of use' envisaged in the Collateral Directive, it is possible to give a secured party the right to dispose of encumbered assets under all circumstances. A security interest, such as a right of pledge, is, however, not compatible with a secured party's general right of disposal. A security interest is intended as a safeguard in the event of a default. While this means that dispositions can take place when there is an event of default, it does not mean that the secured party has a general right of disposal. Moreover, the parties who agree on a security interest are in a fiduciary relationship, in which their interests are balanced. The interests of collateral providers, who are in need of credit and are therefore in a dependent position, are safeguarded by a number of protective mechanisms. In a right of pledge, this fiduciary relationship and the limited character of the right of pledge are, for example, apparent from the general principle that a pledgor can redeem his assets by fulfilling his obligations. By the same token, a pledgee is customarily not allowed to appropriate pledged assets and has a duty of due care in respect of the assets, which, in any case, means that he has no power to dispose of them

for the benefit of a third party. The right of use renders these principles, and thus the fiduciary relationship between the parties, void. It is a conceptual oddity that the generally more powerful collateral taker has the right to revoke the mechanisms protecting the collateral provider at any moment he pleases.²⁰⁰

The theories relating to enforcement and repledge cannot serve as a basis for incorporating the right of use into the Dutch and German systems of property law. Likewise, the German theory on perishable goods, which envisages both a right of disposal and a rule of proprietary substitution, cannot serve as a basis for the right of use. Securities are not perishable, but are consumable goods. Neither can the concept of a non-owner's right of disposal granted on a contractual basis, which is commonly applied in relation to the sale on commission, and – as an explanation for the collateral provider's, but not the collateral taker's right of disposal – in relation to reservation of title arrangements and fiduciary transfers of title, be applied to explain a collateral taker's general right of disposal. When applied in connection with a right of pledge, this concept leads to irreconcilable tensions with core principles of pledge law, particularly with the mechanisms protecting the collateral provider.

The theory of irregular pledge, irregular usufruct and irregular custody best illustrates what the right of use is all about. Ownership passes if consumable assets are made replaceable, i.e. if the beneficiary has the right to dispose of them in exchange for a contractual obligation to transfer equivalent assets at a later moment. The same principle applies in the case of a loan of fungibles. In this case, assets are also made replaceable, which customarily leads to a passing of ownership. Because the structure of the right of use as envisaged in Article 5 of the Collateral Directive is exactly the same as that of an irregular pledge, the right of use can be equated to a transfer of title.

Contrary to this doctrine, the Dutch legislator has recently introduced a right of usufruct combined with a general right of disposal and a rule of proprietary substitution. This choice, however, leads to theoretical and practical problems, particularly if substitute registered claims (*vorderingen op naam*) or immovable property are registered in the name of the usufructuary. It has therefore been argued that the doctrine of irregular

200 See the outline of the principle characteristics of security interests in section 1.3 of chapter III.

usufruct, which entails a transfer of title, should be re-established. Another reason not to take the Dutch law of usufruct as a model upon which to implement the Collateral Directive's right of use, is that a security interest, unlike the right of usufruct, often features an unequal balance of power between the parties, which benefits the collateral taker. From this perspective, it is not desirable to widen the collateral taker's powers with a general right of disposal.

In principle, the theory on the irregular structures mentioned above envisages a passing of ownership at the moment the irregular structure is entered into. It is, however, possible to deviate from this principle and to agree on a passing of ownership at the moment that the general right of disposal is exercised. The Collateral Directive follows this latter approach. Under the Collateral Directive, a transfer of title takes place at the moment that the secured party exercises his right of use. The approach under which ownership passes at a later moment, however, causes tension from a property law point of view as it leads to a diluted concept of ownership. What is the status of the ownership and redemption rights of the collateral provider in the period between the establishment of the security interest combined with a right of use, and the exercise of that right? These rights cannot be equated to the rights that a provider of security normally has. In this case, the security provider's rights are subject only to his own default. If the secured party has a general right of disposal, the security provider's ownership and redemption rights have a far weaker status because they are also subject to the secured party's general right of disposal, which may be executed at any moment in time. Consequently, the collateral provider has hardly anything left to dispose of for the benefit of third parties. It has even been argued that his right of disposal terminates entirely after the establishment of a first security interest combined with a general right of disposal.

As soon as the collateral taker exercises his right of disposal, the collateral provider definitely loses title and is left with nothing but a contractual claim against the collateral taker for the delivery of equivalent assets. He has no proprietary action of revendication. In effect, the only remedy he has, provided the collateral taker cannot fulfil his obligations, is a right of netting. Contractual arrangements regarding netting are generally enforceable under the Collateral Directive.²⁰¹ Nonetheless, if the price of the collateral assets goes up, and in the absence of proper margin mecha-

201 See section 3 of chapter V.

nisms, the collateral provider is left with an unsecured contractual claim. He will, in this case, have to compete with other ordinary creditors on a *pari passu* basis.

The proprietary substitution arrangement proposed in Article 5 of the Collateral Directive is of no use to the collateral provider. The arrangement deviates from traditional rules of proprietary substitution in, for example, Dutch law, under which substitution takes place immediately and automatically in respect of all kinds of replacement assets. The Collateral Directive's rule of proprietary substitution, on the other hand, is limited to equivalent assets after these have been transferred by the collateral taker, usually at the end of a transaction.

The right of use on the basis of a security interest is a deviation from standard practice in the Dutch and German repo, securities lending and derivatives markets, where collateral is customarily provided by way of an outright transfer of title. A general right of disposal is a concept that is at odds with core principles of pledge law. Essentially, this construction can be equated to an outright transfer.

5. CONCLUSION

5.1 Introductory remarks

A secured party's general right of disposal is a new construction that has come into fashion in the American securities markets over the past few decades and has recently been set out in the European Collateral Directive. Some factors that have contributed to its appearance are the wish for liquid financial markets, the economic pressure on financial market participants to make optimal use of assets (including assets pledged to them) and the fungible nature of securities held through intermediaries.

This chapter has investigated the theoretical underpinnings and the practical consequences of a security interest combined with a general right of disposal, which gives a secured party an owner's customary right of disposal (i.e. a right to encumber financial collateral with a limited right, or to transfer it outright). Special attention has been paid to the different interests that are involved when a security interest is combined with a secured party's right of disposal. Generally, a right of use enhances the liquidity of the financial markets, which is to the benefit of all players. A

closely related, but distinct interest is that of the major financial market participants. The interests of the markets in general and of its major players are benefited by easy access to assets. Another interest, one opposed to that of major market participants, considered in this chapter is that of collateral providers.

Section 5.2 summarizes the arguments made in the sections on American, English, Dutch and German law. It shows that a security interest and a general right of disposal are conflicting concepts. With regard to content, a security interest combined with a general right of disposal can be equated to an outright transfer. Section 5.3 briefly recalls the alternative outright transfer method for the provision of financial collateral, which was the topic of chapter III. Section 5.4 argues that the characterisation of a security interest combined with a general right of disposal as an outright transfer can have a value for capital adequacy, accounting and tax purposes. The concluding section 5.5 briefly summarizes the findings of this chapter.

5.2 The security interest approach

5.2.1 General considerations

Generally, if a collateral provider vests a security interest for the benefit of a collateral taker, he vests a limited right in order to secure an outstanding obligation. He expects to retain his ownership interest, unless he defaults on the secured obligation. Different jurisdictions tend to have slightly different approaches with regard to the protection of the position of the provider of a security interest. The focus may, for example, be on the collateral provider's equity of redemption, on the collateral taker's duty of due care, or on the prohibition of appropriation of collateral assets by the collateral taker. Of course, this is merely a question of emphasis, as these different features of security interests are essentially compatible. They give shape to the fiduciary relationship between the parties. They safeguard the ownership interest of the collateral provider and exclude dispositions by the secured party under normal circumstances. A general right of disposal on the basis of a security interest, as set out in Article 5 of the Collateral Directive, does not do justice to these considerations, which balance the interests of the different parties involved.

5.2.2 *United States*

At the end of the nineteenth century and in the first decades of the twentieth century, a right of repledge was commonly applied in the course of margin lending arrangements. This practice was sanctioned in court cases and ultimately led to the recognition of the right to repledge in the UCC. Under American law, an impairing repledge is possible. Relatively recently, the American standard documentation for securities lending and derivatives transactions has taken an even more radical approach, by envisaging a security interest combined with a collateral taker's unlimited right to dispose of assets in the course of his own business. The documentation excludes the collateral provider's equity of redemption and envisages no interest of the collateral provider in the proceeds from a disposal. Moreover, the structure hardly seems compatible with a collateral taker's duty of reasonable care. The structure envisaged in the documentation excludes key characteristics of security interests, and is therefore, arguably, essentially that of an outright transfer. Note that the American repo market shows that the outright transfer method is a perfectly viable way to provide collateral under American law.

5.2.3 *Europe*

The right of use on the basis of a security interest as set out in the Collateral Directive is incompatible with the concept of a security interest under English, Dutch and German law.²⁰²

a. English law

According to English legal principles, the only way a collateral provider can grant a 'right of use' to a collateral taker is by way of an unambiguous outright transfer of all legal and/or beneficial interests. A general right of disposal cannot be granted on the basis of a security interest. The main reason for this is that a right of disposal for a collateral taker is incompatible with equitable principles in relation to security interests, such as the rule 'once a mortgage, always a mortgage', the equity of redemption and the prohibition on collateral benefits.

202 For the approach taken in Danish and Italian law, which coincides on all major issues with that taken in German and Dutch law in particular, see the Right of Use Report

b. Dutch and German law

In the section on Dutch and German law it was investigated whether a secured party's general right of disposal could be explained in a satisfactory way by looking at the circumstances under which a party with a limited right (a pledgee or a usufructuary) can dispose of encumbered assets. The following cases provide no solution for explaining the Collateral Directive's right of use: (1) The theory in relation to the enforcement of a security interest, as it is limited to default situations. (2) The Dutch repledge cannot provide an explanation, as the Collateral Directive's right of use not only allows the establishment of a security interest, but also an outright sale. (3) The doctrine on perishable goods cannot be applied, because the Collateral Directive's right of use relates to securities and cash, which are consumable but not perishable goods. (4) The theory of a non-owner's right of disposal granted on a contractual basis (applied, most importantly, in the case of a sale on commission, and in giving a collateral provider – but not a collateral taker – a right of disposal in reservation of title arrangements and fiduciary transfers of title) also cannot be used as an explanation for the concept of a collateral taker's general right of disposal. This concept is not compatible with the mechanisms protecting the interests of collateral providers and their other creditors, which are characteristic of a security interest.

In my view, the best way to interpret the Collateral Directive's construction is by referring to the irregular structures, i.e. the irregular right of pledge, right of usufruct and custody. The irregular pledge comes closest to what the right of use is all about. In both cases, a general right of disposal is granted to the secured party. The section on Dutch and German law shows that it is the irregular pledge that matches the structure of the right of use envisaged by the Collateral Directive.²⁰³

Security interest combined with a right of use / irregular pledge

203 See also the diagrams and related explanatory comments in sections 4.5.2 and 4.6.2 above.

The irregular pledge and the right of use envisaged in the Collateral Directive coincide on the following points: (1) the security interest is vested to secure a claim of the 'pledgee' against the 'pledgor'; (2) both concepts entail a passing of ownership; (3) the collateral taker can enter into further trading with the 'pledged' assets in the course of his own business; and (4) the parties are under an obligation to transfer equivalent assets at the end of the transaction. A security interest combined with a right of use is therefore essentially an irregular pledge.

The concept of 'replaceability' explains why ownership passes in the case of irregular pledge, usufruct or custody. Replaceability means that (1) the pledgee, usufructuary or custodian can dispose of the asset, and (2) is under a contractual obligation to transfer equivalent assets at a later moment. The result of consenting to such replaceability is that title passes and that the provider of the right of pledge or usufruct, or the client of the custodian, is left with a contractual claim. This claim ranks on a *pari passu* basis in the case of the collateral taker's insolvency.²⁰⁴

Still, also if explained on the basis of the theory on irregular structures, the Collateral Directive's right of use exerts pressure on the system of property law. This is due to the fact that the Collateral Directive deviates from the irregular structures in respect of the ever crucial timing issue. In the irregular pledge, usufruct and custody, it is generally argued that ownership passes at the moment the irregular structure is entered into. The transferor loses his proprietary interest at the moment he consents to replaceability. From that moment on he is left with a contractual claim. It has also been argued, however, that it is possible to deviate from this principal rule on the basis of a contract. The parties can agree that ownership passes at the moment of actual disposal. Article 5 of the Collateral Directive, which envisages that the ownership right of the collateral provider is maintained until the moment the collateral taker chooses to dispose of the pledged assets, follows this latter approach.

204 In a loan of fungibles (*verbruiklening* under Dutch law, *Darlehen* under German law) assets are also essentially made replaceable. That is why under Dutch and German law a loan of fungibles, in principle, also leads to a transfer of ownership

In the period prior to the actual disposal by the collateral taker, the collateral provider still seems to have his ownership and redemption rights. In fact though, his rights are not as solid as they would be in the case of an ordinary security interest without a general right of disposal. Not only are the rights mentioned subject to his own default, they also stop existing when the secured party exercises his right of disposal, which may be at any moment in time. Moreover, once the security provider has granted a right of use to a first secured party, his power to further dispose of the encumbered assets is considerably limited. He can only dispose of rights that are subject to the first secured party's general right of disposal and of a possible future claim for the delivery of equivalent assets. It has sometimes even been argued that his power of disposal ceases to exist at all. In my view, therefore, the original owner does not have a fully fledged proprietary interest in the period until the right of disposal is exercised. In addition, the careful balance between the parties is disturbed. The collateral provider's weak ownership and redemption rights, and the possibility that the secured party can end the fiduciary relationship between the parties at any moment he pleases (one meant precisely to protect the interests of the usually weaker collateral provider), are arguments against treating the structure as a security interest and in favour of treatment as an outright transfer.

Upon a disposal of encumbered assets by the collateral taker, the collateral provider loses his proprietary interest in the encumbered assets definitely as well as his right to redeem the assets concerned. From the moment of actual disposal, he has a contractual claim for the transfer of equivalent assets only. In the event of the collateral taker's insolvency, his only remedy is to set this claim off against the value of the cash or securities received from the collateral taker. If, however, the prices of the financial collateral provided to the collateral taker have gone up (and this in the absence of proper margin arrangements), the collateral provider runs an unsecured credit risk in respect of the collateral taker. In this case his claim will have to compete with the claims of other unsecured creditors on the basis of the *pari passu* principle.

The Collateral Directive says nothing about the question of whether ownership passes through the patrimony of the collateral taker upon a disposal, or falls directly into that of the third party acquirer. Two approaches can be taken. In line with the theory on the irregular structures, one could defend the position that ownership passes through the patrimony of the collateral taker. Alternatively, it is possible to follow the

approach that is often taken in the case of reservation of title arrangements, which means that ownership flows directly from the original owner to the third party acquirer.

The Collateral Directive poses the additional problem of proprietary substitution. Under Dutch law, proprietary substitution is only applied in a limited number of situations, such as in relation to insurance payments or damages due when pledged assets are damaged or destroyed, or in relation to the proceeds from a sale when pledged perishable assets have to be sold. In these instances, proprietary substitution takes place immediately and automatically, and relates to all kinds of replacement assets. The Collateral Directive's rule of proprietary substitution is not compatible with this traditional approach. The Collateral Directive envisages proprietary substitution only in relation to equivalent assets after these have been transferred by the collateral taker, usually at the end of the transaction. This means that the collateral provider has an unsecured exposure towards the collateral taker during the entire course of a transaction. In practice, the Collateral Directive's rule is usually an empty shell, because a collateral taker will only transfer equivalent assets when the secured debt is fulfilled. At this moment, the security interest ceases to exist and proprietary substitution can no longer take place.

5.2.4 Vertical relationships

The Collateral Directive gives rise to an important additional policy issue. The directive's right of use does only not apply to transactions between commercial market participants in, for example, the over-the-counter market, but also to the relationship between a financial institution (e.g. a bank or a custodian) and its clients. A financial institution, with which a client has a securities account, for example, is under a fiduciary duty to take the interests of its clients into account. Compliance with this fiduciary duty is particularly important because a client is often in a weaker position than a financial institution. The right of use is a legal construction with far-reaching legal consequences. The client may not fully realise the consequences of a right of use, because when he grants the financial institution a right to 'use' he may not perceive this as a general right of disposal. The client may nevertheless lose his proprietary interest in securities and be left with a contractual claim.

In line with their fiduciary duties, it is submitted that financial institutions should explain the legal implications of a right of use to their clients. In

my view, financial institutions should explain that a pledge with a right of use is something essentially different from a traditional right of pledge, that there is no prohibition of appropriation, no duty of due care and no right of redemption to protect the client's ownership interest. It is, however, somewhat naive to rely fully on the ability and willingness of commercial banks and custodians to explain to their clients what the implications of a right of use actually are (i.e. that the client loses his ownership right and is left with a contractual claim). Financial institutions are under strong economic pressure to use the assets of their clients. Because their interests are diametrically opposed to those of their clients, it seems advisable not only to oblige financial institutions to inform their clients properly, but also to monitor their behaviour in practice. One may also wonder whether the stipulation of a right of use on the basis of generally applicable conditions is compatible with the financial institution's fiduciary duties.

If the outright transfer method is used, no complicated explanations about the deformed right of pledge are necessary; every investor should understand that he loses his ownership right in this case. It is submitted that an unambiguous transfer of title by the client to the financial institution serves the interests of both parties. The client realises he loses his proprietary interest, and the financial institution is free to dispose of the transferred assets as it wishes. From the point of view of investor protection, the outright transfer method is therefore preferable over a right of use on the basis of a security interest. These considerations are particularly important if the client is not a major financial institution, but a small or medium-sized enterprise.

5.2.5 Theory and its meaning in practice

Has this chapter focused too much on theory and too little on what the law is seeking to achieve? Should theory be set aside for the sake of liquid markets? Promoting liquid markets is, of course, a very important, commendable objective that deserves full support. As was shown in chapter III, liquid markets can easily be achieved by applying the outright transfer method, which is the market standard for the provision of collateral under repo, securities lending and derivatives transactions throughout Europe. The 'cost' of the additional construction of a security interest combined with a right of use is that the distinction between security interests and outright transfers fades. Of course, this has a theoretical side, but theory also serves practical purposes. People have different expectations when

establishing a security interest (they know they retain ownership unless they default on the secured debt), than when transferring title outright (they know they lose their proprietary status irrevocably and will often only have a contractual claim instead). Because the title transfer method is a suitable alternative for the construction found within the Collateral Directive, and has indeed been sanctioned by the Collateral Directive, there is no need to interfere with expectations that have been long established in practice.²⁰⁵

5.2.6 Future developments?

Currently, the construction of a secured party's general right of disposal can be applied in the American and European securities markets. It should, however, be noted that the drafters of a UNIDROIT Preliminary Draft Convention on Substantive Rules regarding Intermediated Securities (who were partly also involved in drafting the Collateral Directive) currently consider an extended application of the construction in the securities markets on a world-wide basis. Moreover, the drafters of the UNIDROIT Convention go further than the Collateral Directive in two respects. They envisage a right of use that, in principle, (1) arises *automatically* in respect of intermediated securities that are credited to a securities account of the collateral taker on the basis of a collateral agreement; and (2) may also be exercised in respect of collateral securities provided by *natural persons*. It may be clear that, in my view, these are regrettable developments.²⁰⁶

They prompt the question of whether a further dissemination of the construction to other market segments is to be expected. Westrik has cautioned against a further erosion of the pledge concept. He points out that it is conceivable that collateral takers will also argue for the application of the concept of a secured party's general right of disposal in other parts of the economy.²⁰⁷

205 See, in the same sense, Fesevur 2005.

206 See UNIDROIT 2006, Study LXXVIII – Doc. 42, March 2006, Appendix 2, chapter V, Article 25 (in connection with Article 5) and Article 27 (in connection with Article 1(r)-(s)).

207 See Westrik 2004 I.

5.2.7 Conclusion

In my view, a security interest and a general right of disposal are two incompatible concepts. A general right of disposal cannot be reconciled with the fiduciary relationship that arises in the case of a security interest. A general right of disposal is at odds with the security provider's right of redemption, the security taker's duty of due care, the prohibition of appropriation (applicable under Dutch and German law), the English rule 'once a mortgage, always a mortgage' and the English rule prohibiting collateral benefits. These different principles of pledge law basically protect the often weaker position of the collateral provider against the stronger position of the collateral taker. It is conceptually inconsistent to give the party against whom the collateral provider is protected (i.e. the collateral taker) the right to end the fiduciary relationship between the parties. My basic argument is, therefore, that when one focuses on content rather than form, the construction has more in common with an outright transfer than with a security interest. Under Dutch and German law, this construction should be characterised as an irregular pledge (i.e. an outright transfer). This would be in keeping with American and English law, in which a security interest combined with a right of use is materially the same as an outright transfer.

5.3 The title transfer approach

It was not necessary to introduce the construction of a security interest combined with a general right of disposal in the Collateral Directive. A right of use can also be granted on the basis of an outright transfer of title. The title transfer method promotes the liquidity of the financial markets equally well and has the additional advantage that its consequences are evident to all parties involved.

The analyses in this chapter clearly show that market participants use the outright transfer method when entering into collateralised transactions. This is the approach of internationally used standard agreements, such as the Global Master Repurchase Agreement (repos) and the Global Master Securities Lending Agreement (securities lending). The European Master Agreement also applies the outright transfer method (repo, securities lending, provision of margin in derivatives transactions). Present practice in Germany and the Netherlands is that repos and securities lending are indeed structured as outright transfers. In the United Kingdom too, collateral is commonly provided on the basis of a transfer of title. This is

illustrated by the ISDA Margin Provisions (English law). The outright transfer method is also a perfectly viable way to provide collateral in the US, and is the standard in the American repo market. As market practice shows, it is certainly possible to reach the goal of liquid markets on the basis of the outright transfer approach.²⁰⁸

5.4 Other issues

This chapter has examined the right of use from a civil law point of view. Section 1.4 of the general introduction mentions a number of additional issues that should be considered, such as the treatment of this construction by custodians, where income and voting rights are concerned, and from the points of view of capital adequacy, accounting and tax regulations. These issues have not been dealt with in this chapter, but a few tentative lines of thought can be suggested in line with the civil law analysis. It is, for example, important that a custodian registers a security interest combined with a general right of disposal as something essentially different from a traditional security interest. If the collateral provider's right to dispose of the encumbered assets any further is terminated upon the establishment of a first security interest combined with a right of disposal, as is sometimes proposed, this should also be registered. Other questions emerge as to who is allowed to receive income payments and, in the case of equity securities, who is allowed to execute voting rights, and from what moment? From a formal legal point of view, ownership only passes upon disposal of the encumbered assets by the collateral taker, even if up to that moment the collateral provider's ownership right is already seriously impaired. Arguably, the rights to receive income payments and to exercise voting rights therefore belong to the original owner until the moment of disposal, whereas after the moment of disposal they belong to the third party transferee. As far as capital adequacy, accounting and tax treatments of the construction are concerned, there seems room for a less formalistic approach that focuses more on content. A secured party's general right of disposal seriously impairs the ownership rights of the original owner and, in fact, renders the mechanisms protecting the interests of collateral providers inoperable. This is, in effect, no security interest. For this reason, it seems appropriate that for capital adequacy, accounting and tax purposes, the construction of a security interest combined with a general right of disposal should be treated as an outright transfer from the moment it has been established.

208 See also chapter III, in particular section 2.

5.5 Concluding remarks

The objective of promoting liquid European cash and securities markets deserves full support. In my view, the construction of a security interest combined with a general right of disposal that has been designed to this end, however, does more harm than good.

A 'right of use' on the basis of a security interest as envisaged in the Collateral Directive gives a collateral taker the right to dispose of his counterparty's assets under all circumstances. This is advantageous for collateral takers, who can now use pledged assets to earn money in the course of their own business. A collateral provider will usually, if in a position to do so, only grant a right of disposal in exchange for lower prices for financial services. The downside of this construction for collateral providers, however, is that the fiduciary protection mechanisms that are customarily in place in the case of a security interest to protect their interests are rendered inoperable because the collateral taker can at any moment in time dispose of the collateral assets. Until a disposal of the encumbered assets by the collateral taker, the collateral provider's ownership and redemption rights therefore have a particularly weak status, whereas the collateral provider loses all proprietary interest at the moment of actual disposal and is left with a contractual claim. A general right of disposal is not compatible with the nature of a security interest and essentially implies an outright transfer. In effect, this construction leads to an unnecessary collapse of the distinction between the concepts of security interest and outright transfer. Unnecessary, because as market practice shows, the achievement of liquid markets could have been reached by sanctioning the outright transfer method only.

In my view, it is not that objectionable to somewhat relax a collateral taker's fiduciary duties if the collateral provider and the collateral taker are equally powerful parties. The Collateral Directive, however, relaxes them substantially, if not fully, and moreover, is not limited to transactions between financial institutions. The directive may also apply to transactions between major financial institutions and small and medium-sized enterprises, or between a custodian and his clients. In such cases in particular, the erosion of the fiduciary relationship between security provider and taker is unacceptable.

The new construction of a security interest combined with a general right of disposal has a shaky theoretical basis, blurs the useful distinction

between outright transfers and security interests, and seeks to enforce the position of collateral takers, who usually occupy a stronger position than collateral providers, in an unprecedented way. With regard to content, this construction can best be characterised and treated as an outright transfer for capital adequacy, accounting and tax purposes, for example.

ENFORCEMENT

1. INTRODUCTION

1.1 Introductory remark

This chapter examines the enforcement regime set out in the Collateral Directive. The Collateral Directive takes a liberal approach to the manner in which rights concerning financial collateral are enforced, such as the enforcement of a security interest or of contractual close-out netting provisions. In addition, the Collateral Directive, in line with the approach taken earlier in the Settlement Finality Directive, requires that certain rules of insolvency law are not applied to financial collateral arrangements.

1.2 The manner of enforcement

The central issue in sections 2 and 3 below is the manner in which rights in respect of financial collateral are enforced under the Collateral Directive. Section 2 relates to the enforcement of financial collateral that has been provided on the basis of a security interest, section 3 deals with the enforcement of financial collateral provided by way of a title transfer. Because the enforcement of financial collateral can take place both in and outside of insolvency, the contents of sections 2 and 3 precede sections 4 and 5, which relate to insolvency law only.

The central issue in section 2 is the enforcement of a security interest. Attention is paid to the procedural requirements that are usually set out in national laws in respect of the enforcement of a security interest, and to the related issue of appropriation. The traditional approach under Dutch (and German) national law is compared to that of the Collateral Directive. The Collateral Directive has a number of far-reaching consequences in this respect, because the directive essentially abolishes the core characteristics of security interests (outlined in section 1.3 of chapter III) of a specified manner of enforcement and the prohibition of appropriation. The issue of the collateral provider's right to surplus value upon enforcement, one of the other core characteristics, is not dealt with in the

Collateral Directive and is also not discussed in this chapter. It must be determined under the national applicable law whether such a right exists.¹

In the case of a title transfer of financial collateral, enforcement upon default usually takes place by way of close-out netting. Contractual close-out netting provisions are the topic of section 3. The Collateral Directive generally sanctions the enforceability of contractual close-out netting provisions. There are, however, important issues that the Collateral Directive leaves undetermined and that must still be decided under national law. Section 3 focuses on four of these topics. These are the issues of reciprocity and commensurability, voidable preference and the moment at which mutual obligations should be valued.

1.3 Insolvency law

The Collateral Directive and the Dutch implementing law are at variance with a number of general principles of Dutch insolvency law. The approach of the Collateral Directive was inspired by the Settlement Finality Directive, under which the retroactive effect of the declaration of insolvency was already abolished and certain legal acts were enforceable even after the declaration of insolvency. This approach has been followed in the Collateral Directive. Moreover, the Settlement Finality Directive determined that the rights of a collateral taker should not be affected by the insolvency of a collateral provider, which means, arguably, that a freeze period, for example, should have no effect on the enforcement of rights that are covered by this directive. Likewise, the Collateral Directive determines that a freeze period should not apply to financial collateral arrangements.

1 For Dutch law, the Minister of Justice has indicated that after the implementation of the Collateral Directive any surplus value upon the enforcement of a right of pledge should also be paid to the collateral provider and his other creditors in line with Article 3:253 of the NCC. Arguably, the same is true for transfers of a fiduciary nature. As a matter of course, no such obligation exists in the event of an outright transfer. See sections 6 and 15 of the Additional Explanatory Memorandum (*Nadere Memorie van Antwoord*), *Eerste Kamer*, 2004-2005, 28 874, E; the Explanatory Comments (*Memorie van Toelichting*), *Tweede Kamer*, 2004-2005, 30 138, no. 3, pp. 18-19; and the Report on a Written Consultation (*Verslag van een schriftelijk overleg*), *Tweede Kamer*, 2005-2006, 30 138, no. 6. See also Van Vliet 2005; and the Dutch Supreme Court's *BTL Lease* case of 18 November 2005, www.rechtspraak.nl, LJN AT8241, which case is also discussed in section 3.4.4 of chapter III.

Section 4 of this chapter deals with the abolition of the retroactive effect of the declaration of insolvency as envisaged in both the Settlement Finality Directive and the Collateral Directive. It also considers the protection of creditors under a financial collateral arrangement against the effects of insolvency after that declaration. As such, it becomes possible to determine by which legal acts the insolvent estate is bound. It is also important to establish whether the insolvent party's counterparty under a financial collateral agreement can enforce his rights immediately or whether he is bound by a freeze period. This issue is addressed in section 5.

1.4 Who benefits from the enforcement regime of the Collateral Directive?

A central issue in this chapter is the question of who benefits from the new enforcement regime of the Collateral Directive and the changes to insolvency law that the directive requires. Is there a special group of creditors that benefits from the new regime? Who has to face the disadvantages of the new regime?

The approach of the Collateral Directive in respect of enforcement has drawn the attention of a number of advisory and legislative bodies. The favouring of one particular group of creditors on the basis of a financial collateral arrangement, in this case, collateral takers, is necessarily detrimental to the position of all other creditors. In response to this the European Economic and Social Committee has noted that:

It is vital to take account of this precedent, which may be extended to other types of creditors and thus pervert the principles of bankruptcy law and the corresponding protection of creditors.²

Likewise, according to the Common Position:

In order to strike the right balance between the need not to enlarge the scope of the Directive unduly to the detriment of the other creditors in an insolvency situation on the one hand and, on the other hand, the need to ensure that the aims of the Directive can be achieved, the Council has found it necessary to introduce in Article 1(3) an option for Member States to limit the scope of the special regime laid down by the Directive to financial collateral arrangements where both parties belong to the institutions of a financial nature set out in Article 1(2)(a) to (d).³

2 See section 3.4 of the Opinion of the Economic and Social Committee.

3 See p. 21 of the Common Position.

In the course of Dutch and German parliamentary history, the discriminatory effects of the Collateral Directive's enforcement regime have also attracted attention. As was mentioned in chapter I, for example, the Dutch Council of State has pointed out that the changes contained in the Collateral Directive in relation to pledge law have negative consequences for collateral providers (and their other creditors), and that the changes required in insolvency law have negative consequences for the position of those creditors who have not concluded a financial collateral agreement.⁴

This chapter investigates the basis of these concerns.

This chapter considers the effects of the Settlement Finality Directive and the Collateral Directive on Dutch bankruptcy proceedings (*faillissement*) regulated in the Netherlands Bankruptcy Act.⁵ Throughout this chapter, the analysis of Dutch law is the central focus of attention.⁶ Sections 2 and 3 contain some comparisons with German law.

4 See the advice of the Dutch Council of State (*Raad van State*), quoted in section 3 of chapter I. See also the debate throughout Dutch and German parliamentary history. For Dutch law see also e.g. Keijser 2004, Westrik 2004 I, Van Erp 2004 I, in particular pp. 540-542, Van Erp 2004 II, Westrik 2004 II, Meulman 2005, Van Erp 2005, Lieverse / Wiggers-Rust 2005; Verstijlen 2005; Snyders 2005, Van Vliet 2005.

5 No attention will be paid to comparable changes in relation to the suspension of payment proceedings (*surseance van betaling*) regulated in the NBC, chapter X ('Emergency regulation') of the Credit System Supervision Act 1992 (*Wet toezicht kredietwezen* 1992), chapter IX ('Emergency regulation') of the Insurance Undertakings Supervision Act 1993 (*Wet toezicht verzekeringsbedrijf* 1993); chapter 8 ('Emergency regulation and insolvency') of the Insurance Undertakings (Benefits in Kind for Funerals) Supervision Act (*Wet toezicht natura-uitvaartverzekeringsbedrijf*). For the changes to these regulations as required by the two directives see Articles I and IIB of the Dutch law implementing the Settlement Finality Directive (*Staatsblad* 1998, 714) and Articles II, V, VI and VII of the Dutch law implementing the Collateral Directive (*Staatsblad* 2006, 15).

6 Note that the Dutch Minister of Justice has appointed an advisory committee on insolvency law (*Commissie Insolventierecht*), which at present is working on a proposal for a thorough revision of the Dutch Bankruptcy Code. For more information see www.justitie.nl. The text below only considers current Dutch insolvency law.

2. THE LIBERAL ENFORCEMENT OF A SECURITY INTEREST AND THE ABOLITION OF THE PROHIBITION OF APPROPRIATION

2.1 Introduction

This section focuses on the approach of the Collateral Directive in respect of the enforcement of a security interest in financial collateral. Article 4 of the Collateral Directive distinguishes two different methods of determining the value of securities that are subject to a security interest. Securities can be sold or appropriated. The value of the securities is determined on the basis of the sale price or, in the case of appropriation, on the basis of the agreement between the parties in this respect. This value, or, if the financial collateral consists of cash, the value of that cash, is subsequently set off against, or applied in discharge of the outstanding obligations of the counterparty.

This section discusses the interrelated issues concerning the manner in which a security interest is enforced (section 2.2) and the prohibition of appropriation (section 2.3). According to the Collateral Directive, it should be possible to enforce a security interest in relation to financial collateral without formal requirements. It also suggests that the prohibition of appropriation, as it is applied under Dutch and German law, for example, should be abolished.⁷

2.2 The enforcement of a security interest without formal requirements

2.2.1 *The traditional approach*

The enforcement of security interests under Dutch and German law has traditionally been subject to strict rules that are, to a large extent, mandatory. The main goal of strict enforcement procedures is to protect the security provider (and his creditors) by preventing abuse and optimising proceeds. As such, enforcement procedures give shape to the fiduciary relationship between the collateral provider and collateral taker. For pledge law, these strict rules of enforcement have been codified in the

7 See also section 8.7 of chapter II and section 1.3 of chapter III above.

Dutch and German civil codes.⁸ In the case of a fiduciary transfer of title, these rules of pledge law were (under old Dutch law) customarily applied by way of analogy. German law is somewhat more liberal in this respect and leaves room for the original owner and the fiduciary to agree on the manner of enforcement themselves.^{9 10}

a. General rules

Under Dutch law, the most important procedural requirements for the enforcement of a right of pledge are the following. Before enforcing a right of pledge, a pledgee must give prior notification of his intention to do so to the debtor, to the pledgor (if this is not the same person as the debtor) and to any other parties involved. The parties can agree, however, that there is no such obligation to notify.¹¹ There are different ways in which the actual enforcement of a right of pledge can take place. One method of enforcement is a sale of the pledged assets in an auction with a public character. By conducting a public sale, the maximisation of the proceeds is guaranteed.¹² Dutch law allows other ways of enforcement, provided permission has been granted by the interim provisions judge (*voorzieningenrechter*). In this instance, the role of the judge guarantees an objective manner of establishing the value of the pledged assets.¹³ A third option, which is often applied in practice, is that the pledgor (or the insolvency administrator in his place) and the pledgee conclude an agreement on a different manner of enforcement. Such an agreement, though, can only be concluded after the moment the pledgee has become entitled to realise his right of pledge. Only from that moment onwards is the pledgor/credit taker no longer in a dependent position. He can now properly represent his interests and the value of the pledged assets can be determined in a fair way.¹⁴ Enforcement must take place in line with one of these three different options. It is not possible to agree on another method of enforcement. After the completion of the enforcement, the debtor must

8 For Dutch law, see Articles 3:248 *et seq.* of the NCC. For German law, see in particular §§ 1221, 1234-1241 and 1245-1246 of the GCC. For the text of a number of key provisions in English, see section 3.3.2 of chapter III.

9 On fiduciary transfers of title see sections 1.3 and 3.2 of chapter III above.

10 On the enforcement of a security interest, see the Principles of European Insolvency Law, in particular § 9 ('Security rights and set-off'), pp. 57-59. On the importance of realising maximum proceeds for the benefit of the joint creditors, see the Principles of European Insolvency Law, § 12, pp. 79-82.

11 See Article 3:249 of the NCC.

12 See Article 3:250 of the NCC.

13 See Article 3:251(1) of the NCC.

14 See Article 3:251(2) of the NCC.

again be notified, unless this obligation has been excluded on the basis of a contract.¹⁵

German law also envisages a notification duty for the pledgee before and after the sale of pledged assets.¹⁶ A public sale is one of the ways in which the actual enforcement can take place.¹⁷ Other methods of enforcement have been envisaged in §§ 1245 and 1246 of the GCC. § 1245 of the GCC allows an agreement between the pledgor and the pledgee for a means of enforcement other than public sale. Essential parts of this agreement, however, can only be concluded after the moment of default, when the pledgor/credit taker is no longer in a dependent position. In addition, § 1246 of the GCC allows other reasonable ways of enforcement, sanctioned by a judge if necessary. In all cases, as in Dutch law, there are mechanisms in place (a public sale, an agreement after the moment of default, or intervention by a judge) that guarantee an objective valuation of the pledged assets.

The rationale of the different methods of enforcement available under Dutch and German law is to generate a fair value so that the rights of the collateral provider and his other creditors will not be prejudiced. In all cases, there is a mechanism in place that guarantees a more or less objective price, such as a public auction, the permission of a judge or an agreement *after* the moment of default. These mechanisms guarantee a level of objectivity, and prevent abuse by the security taker.

b. Cash

If a right of pledge has been established in relation to cash, there is no need for special procedures to establish the value of that cash. On the basis of Article 3:255 of the NCC a pledgee is therefore, under Dutch law, allowed to have recourse to it without delay and without formal requirements, as soon as he can demand the fulfilment of his claim.

c. Securities

For securities that are traded on an exchange or a market, a special enforcement procedure is also laid down by Dutch and German law. In this case, it is crucial to determine a fair price for the securities involved.

¹⁵ See Article 3:252 of the NCC.

¹⁶ See §§ 1234 and 1241 of the GCC.

¹⁷ See §§ 1235-1240 of the GCC.

In order to guarantee a level of objectivity in this respect, both Dutch and German law envisage a role for one or more professional intermediaries in the sale of the securities. The function of this intermediary is the realisation of a fair market price in an unbiased, objective manner. For example, Article 250(2) of the current NCC allows a sale on a market or exchange, but demands that such a sale takes place through a professional intermediary.¹⁸ In order to guarantee an objective price, Article 1201(2) of the old NCC even required the intervention of two professional intermediaries.¹⁹ Likewise, German law envisages a role for an independent intermediary in § 1221 of the GCC.²⁰ The German legislator has explicitly rejected a sale by the pledgee himself, without the intervention of an intermediary:

In Hannover (§ 48) and Oldenburg (Art 21), however, the legislator has gone one step further. First, the execution of the sale of securities with a market price has been left to the pledgee himself. The draft [of the GCC, TK] does not follow this example, because it does not result in insubstantial harm to the security of the pledgor.²¹

In the First Chamber of Parliament, the Dutch Minister of Justice has expressed the view that an intermediary in the sense of Article 250(2) of the NCC does not necessarily have to be independent. The minister is of the view that, if the collateral taker can be qualified as an 'intermediary', the collateral taker can enforce his security himself. This view, though, does not do justice to the function of the intermediary, i.e. obtaining a fair and objective price. The views of the minister have probably been politically motivated by his wish to convince the First Chamber of Parliament of the quality of the first draft Dutch law implementing the Collateral Directive, which was nonetheless rejected. Historically, an intermediary

18 See the Parliamentary History of the NCC, *Boek 3, Vermogensrecht in het algemeen*, Article 3.9.2.11.

19 See Article 1201(2) of the old NCC in Fruin 1990. See also the older and somewhat more elaborate text of Article 1202 of the Netherlands Civil Code of 1838.

20 See the Drafters of the GCC, pp. 859-861 ('*E Befriedigung aus Papieren, welche Borsenkurs haben*').

21 See the Drafters of the GCC, p. 860. Translation TK. Original German text: 'Man ist aber in Hannover (§ 48) und in Oldenburg (Art 21) noch einen Schritt weiter gegangen. Erstens hat man die Ausführung des Verkaufs bei kurshabenden Inhaberpapieren dem Gläubiger selbst überlassen. Diesem Vorgange folgt der Entwurf nicht, weil derselbe der Sicherheit des Verpfänders nicht unwesentlichen Abbruch thut.'

in the sense of Article 250(2) of the NCC has always been truly independent.²²

The importance of an independent intermediary becomes apparent when one considers the concepts of 'market' and 'exchange'. The valuation by intermediaries may not be strictly needed in the case of securities that are listed on a firmly established market or exchange with transparent prices, such as the AEX. In this case, it is relatively easy to establish market prices in an objective manner. This, however, is not true for securities that are not quoted and traded on such a market or exchange. It is much more difficult to determine objective prices in the case of less established markets, such as an alternative trading platform, a market in which only a limited number of market participants take part, or the over-the-counter market. Prices on such markets are not necessarily transparent and it may not instantly be clear whether a higher price can be obtained elsewhere. In such cases, the services of an intermediary are indispensable. Only the intervention of an objective intermediary can, in this case, guarantee optimal proceeds for the collateral provider and his other creditors.

2.2.2 *The liberal approach of the Collateral Directive*

The approach of the Collateral Directive in respect of enforcement differs fundamentally from the traditional approach under Dutch and German law. Under Article 4 of the Collateral Directive a pledgee is able to choose between a sale and, if this has been agreed upon, appropriation.²³ In the case of a sale of securities, the Collateral Directive envisages a liberal enforcement regime. Basically, the Collateral Directive allows every method of sale upon which collateral provider and collateral taker agree. Formal requirements are prohibited.²⁴ This means, for example, that prior notification is no longer needed (such as required under Article 3:249 of the NCC) and that the formal requirements, such as a public sale or the permission of a judge, are also dispensed with (see Articles 3:250 and 251 of the NCC). Even though a prohibition of these formal requirements also means that the protection they offer to the collateral provider and his creditors is relinquished, a number of arguments can be put forward in favour of this approach.

22 See the report of the debate in the First Chamber of the Dutch Parliament on 1 March 2005, EK 17, p. 764.

23 See Articles 4(1) and 4(2) of the CD. The issue of appropriation will be discussed in section 2.3 below.

24 See Article 4(4) of the CD.

The most important reason for the liberal enforcement regime of the Collateral Directive is that formal requirements usually prevent immediate enforcement. By ensuring rapid enforcement, the Collateral Directive intends to promote the continued liquidity of the financial markets. By allowing direct enforcement, contagion effects on the counterparties of a defaulting market participant are limited. This means a reduction of systemic risk. In addition to a limitation of systemic risk, the following arguments can be put forward to justify a deviation from strict rules relating to the enforcement of a security interest. First, the transactions that fall within the scope of the Collateral Directive are usually entered into by large, professional market participants. Because these parties are approximately in an equal power position, they will, as a rule, agree on a reasonable mechanism for valuation. Secondly, the Collateral Directive leaves room for the national legislator to determine that enforcement should take place in a commercially reasonable manner. This test can, however, only take place *a posteriori*, i.e. only after the enforcement has been completed.²⁵ All in all, this means that there are sound arguments in favour of the liberal regime of the Collateral Directive where major market participants are concerned.

However, in the case of small and medium-sized enterprises the arguments that justify a deviation from the traditional enforcement regime are not valid. The volume of the transactions entered into by such enterprises is so much smaller that they can hardly be deemed to pose a risk to the continued liquidity of the markets for cash and securities. In addition, such enterprises are not as powerful as major financial institutions. They are not in a position to stipulate reasonable contractual mechanisms for valuation, which makes it even more important to apply the fiduciary principles that protect their interests. Moreover, because of their limited size, they may not be equipped with the expertise necessary to determine *a posteriori* if securities have been valued in line with commercially reasonable market prices, and thus whether it is feasible to start legal proceedings against their counterparty. Arguably, small and medium-sized enterprises should therefore fall outside the scope of the Collateral Directive, as is allowed by Article 1(3) of the Collateral Directive.

Note that, unfortunately, Article 24 of the March 2006 UNIDROIT Preliminary Draft Convention on Substantive Rules regarding Intermediated Securities, which relates to the enforcement of security interests over

25 On this latter issue, see recital 17 and Article 4(6) of the CD.

intermediated securities, takes a comparable approach. Like the Collateral Directive, this provision sets out a liberal enforcement regime for security interests which can be determined in an agreement between the parties and is not subject to national mandatory rules relating to enforcement.²⁶ The only requirement allowed is that enforcement takes place in a commercially reasonable manner.²⁷ This requirement may indeed prove useful in transactions between major market participants, but, as in the case of the Collateral Directive, it does not necessarily lead to fair results in the case of small entities (or even natural persons)²⁸ that have little if any impact on liquidity and only limited access to relevant information about market prices.

2.2.3 Implementation in the Netherlands

As far as the manner of enforcement is concerned, the Dutch law implementing the Collateral Directive does not pay sufficient attention to the position of collateral providers. The Dutch Minister of Justice has indicated in the course of the parliamentary proceedings that under the new Article 7:54(2) of the NCC a collateral taker who is a professional intermediary (*tussenpersoon in het vak*) is himself allowed to sell the collateral assets on the market to the counterparty of his choice.²⁹ Most financial institutions are indeed professional intermediaries, which means that they can enforce a security interest in respect of financial collateral themselves. This also means that there is no mechanism in place to guarantee that optimum proceeds will be realised for the collateral provider and his creditors. It is clear that this is a deviation from the Dutch law that was in force before the implementation of the Collateral Directive. The most relevant provision in this respect is Article 3:250(2) of the NCC, which in all circumstances requires at least one objective and independent intermediary when a right of pledge in respect of securities is enforced. This provision excludes the enforcement of a security interest by a collateral taker himself. Article 7:54 of the NCC deviates from this traditional ap-

26 See UNIDROIT 2006, Study LXXVIII – Doc. 42, March 2006, Appendix 2, Article 24.

27 See UNIDROIT 2006, Study LXXVIII – Doc. 42, March 2006, Appendix 2, Article 24(4).

28 See UNIDROIT 2006, Study LXXVIII – Doc. 42, March 2006, Appendix 2, Article 27.

29 See the Explanatory Comments (*Memorie van Toelichting*) to Article 7:54 NCC in *Tweede Kamer*, 2002-2003, 28 874, no. 3, p. 17; *Tweede Kamer*, 2004-2005, 30 138, no. 3, p. 18.

proach and under this new provision objective prices are therefore not guaranteed.³⁰

In addition, the Dutch Minister of Justice has failed to appreciate that the terms 'market' and 'market price' are not unequivocal concepts. The minister has argued, on the contrary, that the prices of the securities that fall within the scope of the Collateral Directive and the Dutch implementing law can always be established easily and objectively, without the interference of any third party. This view is not necessarily in line with reality. In respect of securities that are traded on the AEX it may be possible to objectively determine their value. But this is different for other securities, which are traded on other markets, such as alternative trading platforms or the over-the-counter market. The prices on these markets can differ. Taking the big transaction volumes on the collateral markets into account, even a small price difference may have considerable financial consequences.³¹

These issues may not be that important in the relationship between two professional participants in the financial markets, both of which are in an equal power position, and have easy access to information about price levels in different trading platforms. The Dutch regulation, however, makes small and medium-sized enterprises, to a large extent, dependent on the credit taker to whom they have provided collateral, usually a major financial institution. The financial institution has easy access to information, whereas the enterprise usually does not, in any case not to the extent that the collateral taker does. The financial institution therefore has the power to determine how a valuation is to take place. The small or medium-sized enterprise pays for the absence of an independent third party.

30 On the issue of enforcement see also sections 15, 17, 19 and 22 (p 21) of the Additional Explanatory Memorandum (*Nadere Memorie van Antwoord*), *Eerste Kamer*, 2004-2005, 28 874, E. This memorandum does not recognise that there is a substantial difference to the law in force before the Collateral Directive was implemented.

31 On this issue, see *Eerste Kamer*, 2003-2004, B, p 4, *Eerste Kamer*, 2003-2004, 28 874, C, p 6, *Eerste Kamer*, 2004-2005, 28 874, E, sections 15, 17, 19 and 22 (p 21), the report of the debate in the First Chamber of Parliament on 1 March 2005, EK 17, p 753 and p 764, *Tweede Kamer*, 2004-2005, 30 138, no 3, p 13 and pp 17-18. For the approach of the German legislator see *Gesetzentwurf der Bundesregierung, Entwurf eines Gesetzes zur Umsetzung der Richtlinie 2002/47/EG vom 6 Juni 2002 über Finanzsicherheiten und zur Änderung des Hypothekendarlehenbankgesetzes und anderer Gesetze*, Bundesrat, Drucksache 563/03, 15 August 2003, p 21.

The Dutch legislator has tried to mitigate this negative effect in two ways. The first attempt was set out in a Ministerial Amendment (*Nota van Wijziging*), which envisaged that the parties could agree upon a role for the interim provisions judge (*voorzieningenrechter*) in the enforcement proceedings.³² The resulting provision of Article 7:54(4) of the NCC provides no relief, however. If a stronger credit provider is not in favour of a contractual provision on the basis of which a judge has the power to act as an independent third party in the enforcement proceedings, the judge is then 'out of the game'.

The second attempt is the remark by the Minister of Justice that a judge can examine *a posteriori* if enforcement has taken place in a commercially reasonable manner. This approach is in line with Article 4(6) of the Collateral Directive. This latter provision has not led to an explicit implementing provision in Dutch law. In this respect, the Minister of Justice has referred, however, to possible actions by the collateral provider on the basis of contractual default (*wanprestatie*) or tort (*onrechtmatige daad*). Essentially, Articles 3:250 and 251 of the NCC and Article 4(6) of the Collateral Directive are elaborations of the more general principle that parties should behave reasonably and fairly towards one another. For this reason, it is indeed arguable that the party who did not enforce in a commercially reasonable manner can be sued on the basis of either contractual default or tort. Still, this approach fails to touch upon the core of the problem. On what basis should a small or medium-sized enterprise, in the absence of a professional third party, decide if a legal action against the collateral taker has any chance of success? All in all, the lack of specialized, objective information works to the disadvantage of small or medium-sized enterprises.³³

An additional issue of a more technical nature, which has received quite a lot of attention in the course of the implementation of the provisions of the Collateral Directive relating to the enforcement of a right of pledge over financial collateral, concerns the relationship between the provisions of the NCC concerning the right of pledge and set-off. Under traditional Dutch pledge law, a pledgee sells pledged assets upon default and has recourse to the proceeds. Because he has no obligation to hand over the sale proceeds to the pledgor before he has had recourse (*afdrachtverplicht-*

32 See *Tweede Kamer*, 2003-2004, 28 874, no. 7.

33 For the view of the Dutch Minister of Justice see sections 15, 17, 19 and 22 (p. 21) of the Additional Explanatory Memorandum (*Nadere Memorie van Antwoord*), *Eerste Kamer*, 2004-2005, 28 874, E.

ting) – he is only obliged to pay the pledgor any surplus value upon recourse – there is no possibility of invoking the set-off of such an obligation to hand over the sale proceeds and the secured claim. Nevertheless, in Article 7:54(1) of the NCC the Dutch legislator follows Article 4 of the Collateral Directive, which primarily seems to use set-off terminology in an economic sense, in applying set-off (*verrekening*) terminology in relation to the enforcement of a right of pledge over financial collateral.³⁴ This is remarkable because under Dutch law, the right of pledge and set-off are two distinct legal constructions, each subject to separate legal provisions notably in Book 3 and Book 6 of the NCC. The approach of the Dutch legislator therefore leads to some confusion. Should the general pledge or set-off provisions be applied in addition to Article 7:54 of the NCC when a right of pledge in respect of financial collateral is enforced? Pursuant to parliamentary questions in this respect, the government has put forward that, in principle, the provisions of pledge law prevail, whereas set-off provisions can only be applied when they do not conflict with provisions of pledge law. An easier, somewhat less confusing approach would have been to implement Article 4 of the Collateral Directive by referring exclusively to the Dutch provisions of pledge law.³⁵

2.3 No prohibition of appropriation?

The issue of appropriation is closely related to the mandatory enforcement regime discussed in section 2.2 above. Under general rules of both Dutch and German law, a contractual provision that gives a pledgee the power to appropriate pledged assets is void.³⁶ This is self-evident, because if such a provision were valid, it would be possible to avoid the mandatory rules of enforcement. If the parties could simply agree on appropriation by the collateral taker, there would be no mechanism that would guarantee an objective valuation of the pledged assets. In practice, a collateral taker can appropriate but only if the formal requirements concerning the manner of enforcement, which were discussed above, have been met. The rationale of this combination of different provisions is the prevention of misuse by a dominant collateral taker, and the optimisation

³⁴ See also Article 7:53(3) of the NCC.

³⁵ On this issue, see *Eerste Kamer*, 2004-2005, 28 874, D, p. 3; *Eerste Kamer*, 2004-2005, 28 874, E, section 6; the report of the debate in the First Chamber of Parliament on 1 March 2005, EK 17, p. 752 and p. 761; *Tweede Kamer*, 2004-2005, 30 138, no. 3, p. 14 and p. 17. See also the debate on this issue in *Lieverse / Wiggers-Rust* 2005; *Verstijlen* 2005, section 4.2; *Faber* 2005, no. 111.

³⁶ See Article 3:235 of the NCC and § 1229 of the GCC.

of proceeds for the benefit of the collateral provider and his other creditors. After all, a prescribed method of enforcement offers more guarantees that maximum proceeds will be realised, than appropriation and valuation on the basis of a contract that has possibly been dictated by the collateral taker.

The Collateral Directive deviates from the traditional approach under Dutch and German law, in that it allows parties to agree that pledged securities are appropriated and that their valuation takes place in accordance with contractual provisions.³⁷ Generally, this new approach is favourable to collateral takers and detrimental to collateral providers and their creditors.

On the basis of Article 4(3) of the Collateral Directive, those Member States of the European Union that do not recognise the appropriation method are allowed to ignore this method when implementing the directive. However, the prohibition of appropriation has little added value if the requirements for the enforcement of a security interest are abolished. A collateral taker who would wish to appropriate the assets could simply sell them to an affiliated entity – without being hindered by tedious requirements – and subsequently, buy them back from that entity. In addition, it has been argued in section 2.2 on the enforcement of security interests above that there are good reasons for a liberal enforcement regime in the case of major market participants. For the same reasons, contractual arrangements in respect of appropriation are acceptable in the case of transactions between market participants who are equally powerful. That the prohibition of appropriation can be removed when major financial market participants are concerned is therefore a position easy to defend.

It is, however, quite unacceptable that the interests of weaker market participants, such as small and medium-sized enterprises, are simply cast aside. The strict enforcement procedures and the prohibition of appropriation are features of the fiduciary relationship between collateral provider and taker, the application of which is particularly important in the case of weaker economic players. The combination of the Collateral Directive's liberal enforcement regime and the possibility of appropriation is at odds with this objective of protection. Where small and medium-

37 See Article 4(1-2) of the CD. For a comparable approach see the UNIDROIT Preliminary Draft Convention on Substantive Rules regarding Intermediated Securities, UNIDROIT 2006, Study LXXVIII – Doc. 42, March 2006, Appendix 2, Article 24(1)(b).

sized enterprises are concerned, the directive benefits collateral takers to a disproportionate extent. This is a good reason to exclude these enterprises from the scope of the Collateral Directive.

3. CLOSE-OUT NETTING

3.1 Introduction

This section investigates whether national rules relating to netting or set-off³⁸ continue to play a role in light of the Collateral Directive's rule that contractual close-out netting provisions should be enforceable.

3.1.1 What is netting?

When a party invokes netting or a set-off against a counterparty, he essentially fulfils an obligation towards that counterparty even if no actual, physical payments take place. At the same time, he receives payment in respect of a claim which he has against that counterparty (up to the amount of the lesser obligation). The result of netting is that two reciprocal debts are (at least in part) fulfilled. In insolvency, this means that if netting can be enforced by a creditor, then that creditor fulfils an obligation towards the insolvent estate and at the same time receives payment from the estate. A creditor who is in a position to invoke netting is therefore in a better position than creditors who do not have this option. Netting is an exception to the *pari passu* or *paritas creditorum* principle in insolvency, which means that all creditors are treated on an equal footing.³⁹ A right to invoke netting in fact gives a creditor a preferential position, which can be compared to that of a pledgee, for example.⁴⁰ It is for this reason that national systems of law usually impose limitations on set-off, in particular in cases of insolvency.⁴¹

38 No sharp distinction is made between the terms 'netting' and 'set-off'.

39 Under Dutch law, the *pari passu* principle appears in Article 3:277(1) of the NCC. See also the Principles of European Insolvency Law, § 12.2 ('Ranking of claims – *paritas creditorum*'), pp. 81-82.

40 Annex D of the Commission Working Document, pp. 2-3, phrases this as follows: 'close-out netting, to the extent that it applies in the context of insolvency proceedings, may be analysed as involving the appropriation or destruction of an asset of the insolvent party and, therefore, as inconsistent with the principle of *pari passu* distribution of assets among creditors.'

41 On set-off in insolvency see the Principles of European Insolvency Law, § 9.3, pp. 60-61.

3.1.2 Close-out netting under GMRA and GMSLA

As was already outlined above, the standard documentation for repo and securities lending transactions usually contains contractual close-out netting provisions that are applicable in the event of default, including insolvency. The close-out netting process set out in, for example, the GMRA and GMSLA consists of three stages. These stages are (1) early termination and the acceleration of all rights and obligations (automatically or upon notice), (2) valuation of all rights and obligations and, if necessary, conversion into a single currency, and (3) set-off, resulting in a single monetary obligation by one party to the other.⁴²

3.1.3 The approach of the Collateral Directive and the role of national law

The Collateral Directive generally sanctions comparable contractual arrangements that aim at the netting of cash and securities upon the occurrence of an event of default, such as insolvency.⁴³ Article 7 of the directive relates to the 'Recognition of close-out netting provisions' and states:

1. Member States shall ensure that a close-out netting provision can take effect in accordance with its terms:
 - (a) notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of the collateral provider and/or the collateral taker; and/or
 - (b) notwithstanding any purported assignment, judicial or other attachment or other disposition of or in respect of such rights.
2. Member States shall ensure that the operation of a close-out netting provision may not be subject to any of the requirements that are mentioned in Article 4(4), unless otherwise agreed by the parties.

Pursuant to subsection 2 of this provision, close-out netting should not be subject to formal requirements in the sense of Article 4(4) of the Collateral Directive, which determine that:

- (a) prior notice of the intention to realise must have been given;
- (b) the terms of the realisation be approved by any court, public officer or other person;
- (c) the realisation be conducted by public auction or in any other prescribed manner; or
- (d) any additional time period must have elapsed.

⁴² On this issue, see also section 4.7 of chapter II and section 3.3.3.b ('Recovery function') of chapter III.

⁴³ See recitals 5, 14 and 15, and Articles 2(1)(n) and 7 of the CD.

Recital 14 explains the objectives behind the liberal close-out netting regime of Article 7 of the Collateral Directive. It makes clear that close-out netting enables market participants to express the risk in respect of a counterparty on a net basis.⁴⁴ Recital 14 of the Collateral Directive states:

The enforceability of bilateral close-out netting should be protected, not only as an enforcement mechanism for title transfer financial collateral arrangements including repurchase agreements but more widely, where close-out netting forms part of a financial collateral arrangement. Sound risk management practices commonly used in the financial market should be protected by enabling participants to manage and reduce their credit exposures arising from all kinds of financial transactions on a net basis, where the credit exposure is calculated by combining the estimated current exposures under all outstanding transactions with a counterparty, setting off reciprocal items to produce a single aggregated amount that is compared with the current value of the collateral.

On the whole, the Collateral Directive is therefore favourable to the creditor who can invoke netting under a financial collateral arrangement. However, the Collateral Directive does not offer certainty in all respects. As was already mentioned in section 8.7.3 of chapter II, national law still plays an important role when determining if and under what conditions close-out netting can take effect. This continuing role of national law follows from recital 15 of the Collateral Directive. This recital states in general terms that restrictions or requirements under national law relating to set-off (or netting) should be taken into account. By way of an example this recital makes clear that it should be determined under national law whether claims are reciprocal and are thus eligible for set-off. Another issue that should, according to the recital, be considered under national law is whether set-off can take place in light of the knowledge (actual or construed) about his counterparty's insolvency possessed by the party invoking the set-off. This brings to mind rules of voidable preference. The text of recital 15 reads as follows:

This Directive should be without prejudice to any restrictions or requirements under national law on bringing into account claims, on obligations to set-off, or on netting, for example relating to their reciprocity or the fact that they have been concluded prior to when the collateral taker knew or ought to have known of the commencement (or of any mandatory legal act leading to the commencement) of winding-up proceedings or reorganisation measures in respect of the collateral provider.

44 See also section 15 of the Opinion of the European Central Bank.

The approach of recital 15 is remarkable because it thwarts much of what recital 14 and Article 7 of the Collateral Directive aim to achieve. It should be noted that it was introduced at a late stage in the legislative process. Recital 15 first appeared in the text agreed upon by the ECOFIN Council on 13th December 2001.⁴⁵ The ECOFIN text gives no explanation for the sudden appearance of this recital. Its background may be the following. As was indicated above, close-out netting is favourable to the creditor who can invoke netting, but also results in the disappearance of assets to which this creditor's counterparty is entitled, which is disadvantageous to all other creditors of that counterparty. Possibly one or more delegations at the ECOFIN meeting wished to establish some limitations on the liberal netting regime proposed by the Collateral Directive and therefore proposed the text of recital 15. By referring to national law, the national law restrictions on netting again come into play, and they, in turn, determine how the interests of different groups of creditors are taken into account.

In addition to the issues mentioned explicitly in recital 15 of the Collateral Directive, there are also other topics in relation to close-out netting that should be determined under national law, simply because the Collateral Directive is silent on those issues. An important example is the moment in time at which the claims of the parties who are subject to close-out netting should be valued. This issue is not dealt with in the Collateral Directive and should therefore be determined under the national law concerned.

3.1.4 *The approach of the Dutch legislator*

Dutch law contains a liberal set-off regime. The general rules relating to set-off are set out in Articles 6:127 *et seq.* of the NCC, whereas Articles 53 and 54 of the NBC relate to set-off in cases of insolvency.⁴⁶ Article 6:127 of the NCC sets out five requirements for set-off: (1) the claims involved in set-off should be 'reciprocal' or 'mutual', which means that only the claims that two parties have against one another are eligible for set-off (this issue is the topic of section 3.2 below); (2) claims should be 'similar' or 'commensurable'. This means that they should be expressed in the same unit

⁴⁵ See p. 6 of the ECOFIN text.

⁴⁶ On Articles 6:127 *et seq.* of the NCC see, for example, the Asser Series 4-I, chapter 12. On Articles 53 and 54 of the NBC see e.g. the History of the NBC (2-I), pp. 461-465, and Van Setten in Vereecken / Nijenhuis 2003, pp. 259-261. See also Faber 2005 for an analysis of general civil law and insolvency law aspects of set-off.

of account, e.g. cash or apples, or, to put it in the words of Article 6:127(2), that the claims should 'correspond' to one another (this requirement is discussed in section 3.3). Requirements that will not be considered further are (3) that the party invoking set-off should have the right to settle his obligation, and (4) that he should be entitled to enforce the satisfaction of his claim. The final requirement for set-off, which is closely connected to the requirement of reciprocity or mutuality, is (5) that the claim and the obligation involved in set-off should not form part of separate patrimonies.⁴⁷ The text of Article 6:127 of the NCC states:

1. Where an obligor, who has a right of compensation (*set-off*), notifies his obligee that he is compensating (*setting-off*) the obligation against a claim, both obligations shall be extinguished up to their common amount

2 An obligor has a right of compensation (*set-off*) where he has a claim for a prestation (*performance of an obligation*) which corresponds to his obligation to the other party, and where he may settle the obligation and enforce satisfaction of the claim

3 There is no right of compensation (*set-off*) between a claim and an obligation which form part of separate patrimonies (*estates*)⁴⁸

While Articles 6:127 *et seq.* of the NCC concerning set-off apply in principle, they are not provisions of mandatory law. This means that parties can enter into differing agreements in respect of set-off.⁴⁹

In insolvency, Articles 53 and 54 of the NBC apply. These provisions prevail over the general set-off provisions of the Dutch Civil Code. In addition, unlike the provisions of the Civil Code, they are mandatory, because they apply in insolvency and safeguard the interests of the other creditors of the insolvent estate. The Dutch set-off regime in insolvency is, nevertheless, liberal. Article 53 sets out the requirements under which a set-off can take place in insolvency. Article 54 contains some exceptions

⁴⁷ On these five requirements see also Faber 2005, no 15

⁴⁸ Translation Netherlands Business Legislation Original Dutch text '1 Wanneer een schuldenaar die de bevoegdheid tot verrekening heeft, aan zijn schuldeiser verklaart dat hij zijn schuld met een vordering verrekenet, gaan beide verbintenissen tot hun gemeenschappelijk beloop teniet 2 Een schuldenaar heeft de bevoegdheid tot verrekening, wanneer hij een prestatie te vorderen heeft die beantwoordt aan zijn schuld jegens dezelfde wederpartij en hij bevoegd is zowel tot betaling van de schuld als tot het afdwingen van de betaling van de vordering 3 De bevoegdheid tot verrekening bestaat niet ten aanzien van een vordering en een schuld die in van elkaar gescheiden vermogens vallen '

⁴⁹ See Faber 2005, nos 118-125

that will not be discussed here. The main rule of Article 53(1) of the NBC is:

A person who is both a debtor and a creditor of the bankrupt may set-off his debt against his claim against the bankrupt provided each arose before the declaration of bankruptcy, or if they resulted from legal acts entered into with the bankrupt before the declaration of bankruptcy.⁵⁰

Under Article 53 of the NBC, obligations can in principle therefore be set off if they have 'pre-insolvency roots'. This means that both obligations must have arisen before the declaration of insolvency, or must result from legal acts entered into with the insolvent entity before the moment insolvency was declared. If these requirements are met, contractual netting arrangements are also generally enforceable in insolvency.⁵¹

When implementing Article 7 of the Collateral Directive, the Dutch legislator had the Dutch liberal set-off regime both in and outside of insolvency in mind, and argued that no explicit provision was needed in Dutch law to guarantee the enforceability of contractual close-out netting provisions. The Collateral Directive has, therefore, not led to a change in Dutch law. This means that it must still be determined under the liberal regime of Articles 6:127 *et seq.* of the NCC and Articles 53 and 54 of the NBC whether close-out netting provisions in financial collateral arrangements are enforceable.⁵²

50 Translation: Netherlands Business Legislation. Original Dutch text: 'Hij die zowel schuldenaar als schuldeiser van de gefailleerde is, kan zijn schuld met zijn vordering op de gefailleerde verrekenen, indien beide zijn ontstaan vóór de faillietverklaring of voortvloeien uit handelingen, vóór de faillietverklaring met de gefailleerde verricht.'

51 Under Dutch law which was in force before the implementation of the Collateral Directive, contractual close-out netting provisions were – except for a few minor impediments – generally considered to be enforceable. This issue is addressed in legal opinions of major law firms commissioned by trade organisations, such as those relating to the enforceability of the GMRA under Dutch law. On this issue, see also the Netherlands Annex to the GMRA and the Guidance Notes thereto. In addition, see Graaf 1998/1999, section 5; Nijenhuis / Verhagen 1994; Nijenhuis 1998; Rank 1998 II, pp. 399-402; Wessels 1997 II. On set-off in insolvency generally, see Faber 2005, in particular chapter 8.

52 See *Tweede Kamer*, 2002-2003, 28 874, no. 3, p. 9 ('Verrekenbeding'); *Tweede Kamer*, 2004-2005, 30 138, no. 3, pp. 10-11 ('Verrekenbeding').

3.1.5 *The contents of this section*

This section focuses on the continuing importance of national law for close-out netting after the implementation of the Collateral Directive. Section 3.2 deals with the issue of reciprocity or mutuality that, according to recital 15 of the directive, should be considered under national law. Section 3.3 deals with the requirement of similarity or commensurability. Another issue that, according to recital 15 of the Collateral Directive, should be examined under national law is that of voidable preference, which is the topic of section 3.4. An issue that the Collateral Directive does not address, and that must for this reason be determined under national law, is the moment at which claims that are subject to close-out netting should be valued (see section 3.5).

3.2 **Reciprocity or mutuality**

3.2.1 *Introduction*

As was mentioned in section 3.1.3, the Collateral Directive generally sanctions contractual close-out netting arrangements in the event of default. Recital 15 of the Collateral Directive, however, makes clear that it must be determined under the applicable national law whether claims are reciprocal and are thus eligible for set-off. In this context, reciprocity means that there should be a correspondence between the parties who are involved in set-off. The requirement that there is such a correspondence is also referred to as mutuality.

After a note on terminology, this section examines how the requirement of mutuality appears in the absence of a netting agreement. In this respect, the traditional approach under Dutch law and, by way of a comparison, the approaches of the Principles of European Contract Law and the UNIDROIT Principles of International Commercial Contracts will be explored. Whether it is possible under Dutch law to deviate from the mutuality requirement in a netting contract, and whether such a contract is enforceable in insolvency will then be examined.

3.2.2 *A note on terminology*

The term 'reciprocity' is applied in recitals 14 ('reciprocal items') and 15 ('reciprocity' of claims) of the Collateral Directive. The Dutch translation of the Collateral Directive in this respect applies the term *wederkerigheid*,

whereas the German translation, for example, features the term *Gegenseitigkeit*. That reciprocity should indeed be interpreted as a correspondence between the creditors involved in netting, as 'mutuality', is confirmed by the Dutch legislator, who interprets the term as such.⁵³ Fawcett, too, relates the reference to reciprocity in the Collateral Directive to the requirement of the mutuality of the creditors.⁵⁴ Another issue of correspondence, i.e. that of the claims that are subject to set-off, is dealt with in section 3.3 on 'similarity' or 'commensurability' below.

3.2.3 Dutch law

Under Dutch law, the mutuality requirement is set out in Article 6:127 of the NCC. Section 2 of this provision, which was quoted above in section 3.1.4, requires that the same two parties owe the fulfilment of an obligation towards each other. Moreover, section 3 of Article 6:127 of the NCC requires that the obligations concerned should form part of the same patrimonies. This latter aspect of mutuality means, for example, that a party who has an obligation towards his counterparty in a personal capacity cannot set off this obligation and a claim against that counterparty in his capacity as a trustee.⁵⁵

3.2.4 European Principles of Contract Law

Like Dutch law, the European Principles of Contract Law ('European Principles') also require mutuality in principle. Article 13:101 of the European Principles sets out the 'Requirements for Set-Off', and requires that 'two parties owe each other obligations'. The text of this provision reads as follows:

If two parties owe each other obligations of the same kind, either party may set off that party's right to performance ("claim") against the other party's claim, if and to the extent that, at the time of set-off, the first party:

- (a) is entitled to effect performance; and
- (b) may demand the other party's performance.

53 See *Tweede Kamer*, 2002-2003, 28 874, no. 3, p. 9 ('*Verrekenbeding*'); *Tweede Kamer*, 2004-2005, 30 138, no. 3, pp. 10-11 ('*Verrekenbeding*').

54 See Fawcett 2005, pp. 296-297 ('Mutuality').

55 On the mutuality requirement under Dutch law, see the Asser Series 4-I, section 533; Faber 2005, nos. 24-42 and 86-92. For English law, see Derham 2003, chapters 11, 12, 13; Wood 1994, chapter 13; Wood 1995 II, sections 8-1 – 8-4 and 12-10.

The European Principles do not explicitly mention the requirement that the obligations subject to set-off should fall within the same patrimonies.

3.2.5 UNIDROIT Principles

Like the European Principles, the UNIDROIT Principles of International Commercial Contracts ('UNIDROIT Principles') also require mutuality. Article 8.1 of the UNIDROIT Principles is a general provision, which relates to the 'Conditions of set-off', and which requires that 'two parties owe each other money or other performances'. The full text of subsection 1 of Article 8.1 reads as follows:

Where two parties owe each other money or performances of the same kind, either of them ("the first party") may set off its obligation against that of its obligee ("the other party") if at the time of set-off,

- (a) the first party is entitled to perform its obligation;
- (b) the other party's obligation is ascertained as to its existence and amount and performance is due.

The Comments to this provision make clear that each party should be the obligor and the obligee of the other. Moreover, the parties should act in the same capacity.⁵⁶

3.2.6 Contractual arrangements and insolvency

The mutuality requirement of Article 6:127 of the NCC applies in the absence of a contract between the parties. However, as was indicated in section 3.1.4 above, it is permitted to deviate from the set-off provisions of the NCC, in respect of mutuality also, and to agree to different terms in a contract.⁵⁷ For example, it is possible to agree on a netting arrangement involving more than two parties. Whereas under the GMRA and the GMSLA, repo and securities lending transactions typically involve two parties, it is therefore also possible to agree on netting in a structure that involves more parties.⁵⁸

Are contractual provisions that deviate from the mutuality requirement enforceable in insolvency? As was indicated in section 3.1.4 above, the main test in this respect is Article 53(1) of the NBC. This provision is

⁵⁶ See the UNIDROIT Principles 2004, p. 255, section 2.

⁵⁷ See also Faber 2005, nos. 118-125, in particular no. 120.

⁵⁸ On the possibility of deviating from e.g. the mutuality requirement on the basis of a contract see Comment 8 to Article 8.1 of the UNIDROIT Principles 2004, p. 260.

favourable to set-off as long as the claims involved have pre-insolvency roots. This means that a contractual set-off arrangement that deviates from the mutuality requirement is enforceable if the claims involved have arisen before the declaration of insolvency, or result from legal acts entered into with the insolvent entity before the moment of that declaration.⁵⁹

3.2.7 *The Collateral Directive and the role of national law*

This section has shown that the issue of reciprocity, or mutuality, falls outside the scope of the liberal close-out netting regime of the Collateral Directive. Whether mutuality poses restrictions on close-out netting should be determined under national law.

3.3 **Similarity or commensurability**

3.3.1 *Introduction*

Whereas section 3.2 dealt with the requirement of a correspondence between the parties involved in set-off, this section deals with the requirement of a correspondence between the goods that are subject to set-off. Traditionally, set-off can only take place when assets are 'similar' or 'commensurable'. This issue is given special attention because the Collateral Directive relates to close-out netting arrangements that concern different types of assets, such as cash and different types of securities. What is the relation between the liberal close-out netting regime of the Collateral Directive and the similarity or commensurability requirement? Is there still a role for applicable national law when determining whether the requirement of similarity is an impediment to set-off?

This section considers how the requirement of similarity appears in the absence of a netting agreement. In this respect, the traditional approach under Dutch law, and, by way of a comparison, the approaches of the Principles of European Contract Law and the UNIDROIT Principles of International Commercial Contracts will be explored. Whether it is possible under Dutch law to deviate from the requirement of similarity in a netting contract, and whether such a contract is enforceable in insolvency, will then be examined. The focus will then shift to the question of whether

59 See Faber 2005, nos. 397 and 479.

national law still plays a role in this respect after the implementation of the Collateral Directive.

3.3.2 Dutch law

In principle, under Dutch law claims should be similar (*gelijksoortig*) in order to be eligible for set-off. Article 6:127(2) of the NCC, which was quoted in section 3.1.4 above, requires that obligations correspond to one another for set-off. Similar obligations are, for example, obligations in the same currency. Some jurisdictions allow some degree of flexibility as far as the similarity requirement is concerned. A widening of this requirement sometimes occurs in the case of claims that are denominated in different currencies.⁶⁰ It seems unlikely, however, that it is possible to set off obligations expressed in cash and different kinds of securities. The traditional view is that such obligations are not similar.⁶¹

3.3.3 European Principles of Contract Law

The European Principles of Contract Law also require similarity in principle. Article 13:101 of the European Principles, quoted above in section 3.2.4, requires that obligations are 'of the same kind'.

Obligations expressed in different currencies are not of the same kind in the sense of this provision. In order to facilitate the set-off of foreign currencies also, the European Principles contain a special provision relating to the set-off of obligations expressed in different currencies. Article 13:103 of the European Principles relates to 'Foreign Currency Set-Off' and states:

Where parties owe each other money in different currencies, each party may set off that party's claim against the other party's claim, unless the parties have agreed that the party declaring set-off is to pay exclusively in a specified currency.

If the parties have not agreed upon payment in a specified currency, obligations in different currencies can therefore be set off. The European

60 See e.g. Articles 6:121 *et seq.* of the NCC.

61 On the similarity or commensurability requirement under Dutch law see the Asser Series 4-I, no. 534; Faber 2005, nos. 43-57. For English law see Derham 1993, chapter 9; Wood 1994, chapter 19; Wood 1995 II, sections 6-20, 6-33, 6-46 *et seq.*, 12-19. See also Haudek 1936, p. 60 (several jurisdictions); and Eujen 1975, p. 26 (German law), pp. 36-37 (French law), p. 52 (English law).

Principles thereby essentially loosen the similarity requirement somewhat.⁶²

3.3.4 *UNIDROIT Principles*

Like the European Principles, the UNIDROIT Principles also contain a provision that allows foreign currency set-off in spite of the similarity requirement that applies in principle. Article 8.1, section 1 of the UNIDROIT Principles, which was quoted in section 3.2.5 above, requires that performances are 'of the same kind'.⁶³ Article 8.2 of the UNIDROIT Principles concerns 'Foreign currency set-off' and contains a special rule on the set-off of obligations expressed in different currencies. This provision states:

Where the obligations are to pay money in different currencies, the right of set-off may be exercised, provided that both currencies are freely convertible and the parties have not agreed that the first party shall pay only in a specified currency.

Under the UNIDROIT Principles, the set-off of foreign currencies is therefore allowed under certain conditions. The UNIDROIT Principles deviate from the European Principles in that they impose the requirement that the currencies are easily convertible, in addition to the requirement that there is no contractual agreement about payment in a specified currency.⁶⁴

However, the UNIDROIT Principles do not only allow the set-off of different currencies. They contain an even further loosening of the similarity requirement. They also allow the set-off of obligations expressed in cash and securities, if – again – these are easily convertible, and if no agreement has been made on payment in specified cash and/or securities. Comment 3 ('Obligations of the same kind') to Article 8.1 of the Chapter on Set-Off states the following:

Cash and securities are not performances of the same kind in the sense of this article. Nevertheless, as is the case with different foreign currencies, set off may be exercised if the securities are easily convertible and if there is no agreement to the effect that only the payment of specified cash or securities is possible.⁶⁵

⁶² For a critical approach, see Faber 2005, no. 57.

⁶³ See also Comment 3 to Article 8.1 in the UNIDROIT Principles 2004, p. 256.

⁶⁴ See also the comments to Article 8.2 in the UNIDROIT Principles 2004, pp. 260-261.

⁶⁵ See the UNIDROIT Principles 2004, p. 256. For a critical approach, see Faber 2005, no. 57.

3.3.5 Contractual arrangements and insolvency

The similarity requirement of Article 6:127(2) of the NCC applies in the absence of a contract between the parties. This provision does leave room, however, for a contractual departure. It is, for example, possible to agree that non-similar obligations can be expressed in a single unit in order to facilitate netting. This is exactly what occurs in the case of the GMRA and GMSLA. The parties express obligations in one currency, which up to that moment have been expressed in cash and different types of securities. This essentially makes these obligations similar, and makes it possible to set them off.⁶⁶

The requirement that obligations must be similar for set-off can therefore be altered on the basis of contractual provisions. As in the case of the requirement of reciprocity, such contractual provisions are enforceable in insolvency within the boundaries set by Article 53 of the NBC.⁶⁷ Nor is Article 133 of the NBC, which states that claims against the insolvent estate having a value that is not expressed in Dutch currency are to be admitted for their estimated value in Dutch currency, an obstacle to contractual close-out netting. Arguably, this provision relates only to claims that are lodged with the insolvency administrator for the purposes of the verification procedure, and not to claims that are subject to close-out netting provisions.⁶⁸ Transactions involving cash and different types of securities (like those under the GMRA and GMSLA), which have been concluded before insolvency and to which the standard close-out netting provisions of these agreements apply, can therefore successfully be subjected to netting under Article 53 of the NBC.

3.3.6 The Collateral Directive and the role of national law

Recital 15 of the Collateral Directive determines in general terms that the directive 'should be without prejudice to any restrictions or requirements under national law on bringing into account claims, on obligations to set-off, or on netting'. As examples, recital 15 mentions national rules on reciprocity (see section 3.2 above) and voidable preference (see section 3.4 below). In addition, the similarity requirement arguably falls within the scope of the generally stated first sentence of recital 15, even if it has not

66 See Faber 2005, nos. 118-125, in particular no. 120.

67 See Faber 2005, no. 479.

68 On Article 133 of the NBC see the History of the NBC (2-II), pp. 132-133; Rank 1998 II, pp. 400-401; Graaf 1998/1999, section 5; Faber 2005, no. 397.

been explicitly mentioned as an example. Strictly speaking, this means that it must be determined under national law whether the issue of similarity poses an obstacle to the close-out netting envisaged in, for example, repo and securities lending contracts. This interpretation, however, is opposed to the general aim of recital 14 and Article 7 of the Collateral Directive, which are intended to guarantee the enforceability of close-out netting provisions in comparable contracts that relate to cash and different kinds of securities. It is not clear which of these conflicting approaches will prevail.

In the Netherlands, in any case, the issue must arguably be determined under national law, because the Dutch legislator has not implemented Article 7 of the Collateral Directive (see section 3.1.4 above). This, however, poses no problem, because as was shown above, under Dutch law, contractual arrangements relating to the netting of obligations expressed in different units, such as cash and/or different types of securities, are generally enforceable, in insolvency also.

3.4 Voidable preference

Another issue that recital 15 of the Collateral Directive – in somewhat woolly language – mentions as being subject to national law, relates to the question of whether claims can be taken into account for the purpose of close-out netting in connection with the moment they came into existence. It is particularly important to establish whether claims have come into existence prior to the moment that the insolvent party's counterparty came to know or ought to have known of the insolvency, or after that moment. If such claims came into existence after that moment, national rules concerning voidable preference (*actio pauliana*) may come into play. This is because close-out netting in relation to such claims could, in fact, give the insolvent party's counterparty a preferential position to the detriment of all other creditors. Whether or not such a preferential position is acceptable should be determined under national rules of law, notably under those relating to voidable preference.⁶⁹ The reference in recital 15 to rules of national law in this respect coincides with the approach of recital 16 and Article 8(4) of the Collateral Directive, which also refer to general rules of national insolvency law relating to the avoidance of

69 For Dutch law, see Articles 42 *et seq.* and Articles 54 and 55 of the NBC. For a Dutch legal analysis of set-off on the eve of insolvency, see Faber 2005, in particular chapter 7. See also the Principles of European Insolvency Law, § 8 ('Reversal of juridical acts'), pp. 53-57.

transactions which were entered into during a prescribed period before insolvency and are to the detriment of the other creditors.⁷⁰

3.5 Moment of valuation

3.5.1 Introduction

Another issue in which national law comes into play relates to the moment at which the obligations that are subject to contractual close-out netting should be valued. This moment has not been established in the Collateral Directive and must therefore be determined on the basis of national law.

This section focuses on the moment of valuation in the event of an insolvency. It investigates when the valuation should take place under Dutch law. Should the valuation take place the moment a judge declares that the state of insolvency commences, or can the parties also agree upon another moment for the purpose of valuation? This section considers the approach of standard agreements such as the GMRA and the GMSLA, before determining what the moment of valuation should be under Dutch law. Particular attention is paid to the Dutch fixation principle and to Article 38 of the Dutch NBC. Comparisons will also be made with § 104 of the German Insolvency Statute (*Insolvenzordnung*), and with the moment at which pledged assets are valued.

3.5.2 GMRA and GMSLA

In line with the close-out netting provisions of the GMRA and GMSLA, the moment when the valuation of obligations takes place is usually after the declaration of insolvency. This is so because the GMRA and GMSLA envisage valuation procedures that, as a rule, should be completed within a time frame of five business days.⁷¹

The agreements envisage several ways to determine the value of obligations. One of these is to sell the assets that should otherwise have been transferred to the counterparty in the transaction, or in case that counterparty was under an obligation to transfer assets, to buy replacement assets

70 See also *Tweede Kamer*, 2002-2003, 28 874, no. 3, p. 9 ('*Verrekenbeding*'); *Tweede Kamer*, 2004-2005, 30 138, no. 3, pp. 10-11 ('*Verrekenbeding*').

71 See Paragraphs 10(d)(ii) and 10(e) of the GMRA and Paragraphs 10.3-5 of the GMSLA.

in the market. The sale or purchase price can, in this case, be used to establish the actual business value of the obligations that are subject to close-out netting.⁷² Another way to determine the value of a claim or obligation in respect of securities is to obtain price quotations from a number of market makers or regular dealers.⁷³ If such methods cannot be applied, it is basically the non-defaulting party who establishes a fair market value.⁷⁴

Corrigan, Georgiou and Gollow have explained why a 'dealing window' of several business days may be needed in order to complete such valuation procedures. They use the Barings case as an illustration. Barings went into administration in London on a Sunday. News about the administration only reached the Asian markets, which are a considerable number of time zones ahead, after the close of business on Monday. This meant that market participants could only enter into replacement transactions, and thereby determine the actual value of the mutual obligations, on Tuesday. A 'dealing window' for entering into replacement transactions can therefore be justified on the basis of the argument that markets operate in different time zones. A dealing window of five days, however, seems generous from this perspective.⁷⁵

3.5.3 *Fixation principle*

The approach set out in the standard documentation, which envisages a valuation period of up to five days, does not seem to be compatible with the fixation principle under Dutch law. At the moment the insolvency is declared, the insolvent estate is fixated. At this moment, it is determined which assets fall within or outside of the insolvent estate. This fixation guarantees the position of the creditors of the insolvent entity. It could be argued that the moment of the declaration of insolvency should also be decisive for the valuation of assets that fall within the insolvent estate and that are subject to a close-out netting arrangement. If the moment of

72 This method of valuation is set out in, for example, Paragraph 10(e)(i)(A) of the GMRA and Paragraph 10.5 of the GMSLA.

73 Paragraph 10(e)(i)(B) of the GMRA requires quotes from two or more market makers or regular dealers. Compare the role of the intermediary in establishing the value of pledged securities, discussed in section 2.2.1.c above.

74 See Paragraph 10(e)(i)(C) of the GMRA, and Paragraph 10(e)(ii) in conjunction with Paragraph 10(d)(iv) of the GMRA. See Paragraph 10.4 of the GMSLA in conjunction with the definitions of 'Bid Value' and 'Offer Value' in Paragraph 10.1 of the GMSLA.

75 See Corrigan / Georgiou / Gollow 1999, p. 116.

valuation occurs after that of the declaration of insolvency, the other creditors of the insolvent estate are exposed to price fluctuations. If prices go down, any possible surplus value will be reduced and they will receive less money. But if prices go up, they will receive more if any surplus is available. There is clearly an area of tension between this speculation at the risk of all other creditors and the fixation principle.⁷⁶

3.5.4 *Netherlands Annex to GMRA 2000*

Because of the fixation principle under Dutch insolvency law, it is uncertain whether the default market value can be calculated in line with the provisions of the GMRA or GMSLA on a date possibly falling after the declaration of insolvency. For repos, Paragraph 6(c) of the Netherlands Annex to GMRA 2000 addresses this issue by moving the moment of valuation, if necessary, to the day of the declaration of insolvency, or, if this is not a dealing day, to an earlier day.⁷⁷ There is no comparable official annex to the GMSLA for securities lending agreements.

3.5.5 *Article 38 of the NBC*

In addition to the fixation principle, Article 38 of the NBC also points in the direction of a valuation at the moment of insolvency. This provision reads as follows:

If, in the case of article 37 [relating to not or not fully performed mutual contracts generally; TK], delivery of goods traded in the commodity market is stipulated at a fixed time or within a certain period and if such time arises or such period expires after the bankruptcy order, the agreement will be cancelled by the bankruptcy order and the counterparty of the bankrupt, may, without more, lodge a claim for damages as an unsecured creditor. If the estate suffers a loss because of such cancellation, the counterparty must compensate such loss.⁷⁸

76 On close-out netting and the fixation principle see Graaf 1998/1999, p. 194, Rank 1998 II, p. 400. On the fixation principle generally see Van Hees 2000. See also the Principles of European Insolvency Law, § 3.4, p. 40.

77 See also the Guidance Notes to the Netherlands Annex, section 5.3.

78 Translation: Netherlands Business Legislation. Original Dutch text: 'Indien in het geval van artikel 37 de levering van waren, die ter beurze op termijn worden verhandeld, bedongen is tegen een vastgesteld tijdstip of binnen een bepaalde termijn, en dit tijdstip invalt of die termijn verstrijkt na de faillietverklaring, wordt de overeenkomst door de faillietverklaring ontbonden en kan de wederpartij van den gefailleerde zonder meer voor schadevergoeding als concurrent schuldeischer opkomen. Lijdt de boedel door de ontbinding schade, dan is de wederpartij verplicht deze te vergoeden.'

Article 38 of the NBC sets out a special rule in relation to mutual agreements which relate to goods that are traded on a market, and which give rise to obligations that should be fulfilled at a moment that falls after the declaration of insolvency. It envisages the cancellation (*ontbinding*) of such agreements when insolvency is declared.⁷⁹

One question that arises in connection with this provision is whether it only applies to contracts relating to commodities (*waren*), such as grain, sugar or coffee, or also to agreements involving financial collateral. Nijenhuis has investigated whether Article 38 of the NBC applies to certain derivatives contracts, such as swaps, and futures and forwards. He argues that such derivatives transactions do not concern commodity goods (*waren*) in the sense of Article 38 of the NBC, but rather obligations to pay money. This, however, is a rather formalistic approach. As Wood points out, the financial markets as they exist today simply did not yet exist at the end of the nineteenth century, when Article 38 of the NBC was enacted.⁸⁰ In my view, the possibility that courts will follow the alternative approach suggested by Nijenhuis, i.e. that they will apply Article 38 of the NBC by way of analogy to derivatives transactions, certainly cannot be excluded. This is because the rationale of this provision (i.e. a cancellation creates immediate clarity for all the parties involved) can be applied to commodity, but equally as well to derivatives transactions.⁸¹ That Article 38 of the NBC applies to repo and securities lending transactions seems even more likely, because these transactions do not only involve obligations to pay money, but also to transfer securities. The legislator has explicitly indicated that this provision applies to transactions involving securities.⁸²

A second question that arises in connection with Article 38 of the NBC (and one that is more relevant in the context of this section), is the moment at which assets should be valued after cancellation. In relation to the moment of valuation, Nijenhuis states that valuation should probably take place at the moment of the declaration of insolvency. He points out

79 This provision, relating to goods traded on a commodity market, is an exception to the principle that no automatic termination takes place when insolvency is declared. See the Principles of European Insolvency Law, § 6.1 ('No automatic termination'), p. 46.

80 See Wood 1994, p. 25.

81 See in particular Nijenhuis 1998. See also Nijenhuis / Verhagen 1994, p. 100.

82 See the History of the NBC (2-I), p. 416. On Article 38 of the NBC and on comparable provisions in other countries, see also Wood 1994, chapter 9.

that this approach follows from the fixation principle.⁸³ The view that the moment of valuation should, under Article 38 of the NBC, indeed take place at the moment of the declaration of insolvency also follows explicitly from the parliamentary history of this provision.⁸⁴ For this reason, Article 38 of the NBC could be presented as an argument against a valuation procedure of up to five days after the declaration of insolvency (as set out in, for example, the GMRA and the GMSLA), and in favour of the valuation of financial collateral at the moment of the declaration of insolvency.

3.5.6 § 104 of the German Insolvency Statute

German law contains a provision that is comparable to Article 38 of the NBC. § 104 of the German Insolvency Statute (*Insolvenzordnung*) relating to 'Fixed-date transactions. Financial performance' reads as follows:

(1) If the delivery of goods with a market or stock exchange price was agreed to take place exactly on a definite fixed date or within a definite fixed period, and if such date or expiry of the period occurs after the insolvency proceedings were commenced, performance may not be claimed, but only claims for non-performance.

(2) If financial performance with a market or stock exchange price was agreed to take place at a fixed date or within a fixed period, and if such date or expiry of the period occurs after the insolvency proceedings were commenced, performance may not be claimed, but only claims for non-performance. In particular the following shall be regarded as financial performance

1. the delivery of precious metals,
2. the delivery of securities or comparable rights if it is not intended to obtain a participation in a company in order to establish a long-term association,
3. performances in specie which have to be effected in foreign currency or in a mathematical unit,
4. performances in specie, the amount of which is indirectly or directly determined by the exchange rate of a foreign currency or mathematical unit, by the interest rate prevailing for claims or by the price of other goods or services,
5. options and other rights to deliveries or performances in specie in the meaning of Nos. 1 to 4,
6. financial collateral in the sense of § 1(17) of the German Banking Act (*Kreditwesengesetz*).

If transactions concerning financial performances are combined in a framework contract for which agreement has been reached that in the case of violations of the contract it may only be terminated uniformly, the totality of these transactions shall be regarded as a mutual contract within the meaning of §§ 103, 104.

(3) The claim for non-performance shall cover the balance between the agreed price and the market or stock exchange price prevailing at the place of performance for

83 See Nijenhuis 1998, p. 615.

84 See the History of the NBC (2-I), p. 417.

a contract with a comparable term at a moment agreed upon by the parties, but at the latest on the fifth working day after the insolvency proceedings were commenced. If the parties have not come to an agreement, the second working day after the insolvency proceedings were commenced is the norm. The other party may bring such a claim only as a creditor of the insolvency proceedings.⁸⁵

§ 104 of the German Insolvency Statute relates to goods (*Waren*) and financial performances (*Finanzleistungen*) with a market or stock exchange price. Like Article 38 of the Dutch NBC, § 104 of the German Insolvency Statute also envisages the termination of transactions which provide for

85 The translation is based on the translation of the text of the Insolvency Statute as it stood on 1 January 2004, found on the website of the German Ministry of Justice (www.bmj.bund.de), and has been adapted by the author to take into account amendments to § 104 of the Insolvency Statute resulting from the implementation of the Collateral Directive. Original German text:

§ 104 Fixgeschäfte. Finanzleistungen

(1) War die Lieferung von Waren, die einen Markt- oder Börsenpreis haben, genau zu einer festbestimmten Zeit oder innerhalb einer festbestimmten Frist vereinbart und tritt die Zeit oder der Ablauf der Frist erst nach der Eröffnung des Insolvenzverfahrens ein, so kann nicht die Erfüllung verlangt, sondern nur eine Forderung wegen der Nichterfüllung geltend gemacht werden.

(2) War für Finanzleistungen, die einen Markt- oder Börsenpreis haben, eine bestimmte Zeit oder eine bestimmte Frist vereinbart und tritt die Zeit oder der Ablauf der Frist erst nach der Eröffnung des Verfahrens ein, so kann nicht die Erfüllung verlangt, sondern nur eine Forderung wegen der Nichterfüllung geltend gemacht werden. Als Finanzleistungen gelten insbesondere

1. die Lieferung von Edelmetallen,
2. die Lieferung von Wertpapieren oder vergleichbaren Rechten, soweit nicht der Erwerb einer Beteiligung an einem Unternehmen zur Herstellung einer dauernden Verbindung zu diesem Unternehmen beabsichtigt ist,
3. Geldleistungen, die in ausländischer Währung oder in einer Rechnungseinheit zu erbringen sind,
4. Geldleistungen, deren Höhe unmittelbar oder mittelbar durch den Kurs einer ausländischen Währung oder einer Rechnungseinheit, durch den Zinssatz von Forderungen oder durch den Preis anderer Güter oder Leistungen bestimmt wird,
5. Optionen und andere Rechte auf Lieferungen oder Geldleistungen im Sinne der Nummern 1 bis 4,
6. Finanzsicherheiten im Sinne des § 1 Abs. 17 des Kreditwesengesetzes.

Sind Geschäfte über Finanzleistungen in einem Rahmenvertrag zusammengefaßt, für den vereinbart ist, daß er bei Vorliegen eines Insolvenzgrundes nur einheitlich beendet werden kann, so gilt die Gesamtheit dieser Geschäfte als ein gegenseitiger Vertrag im Sinne der §§ 103, 104.

(3) Die Forderung wegen der Nichterfüllung richtet sich auf den Unterschied zwischen dem vereinbarten Preis und dem Markt- oder Börsenpreis, der zu einem von den Parteien vereinbarten Zeitpunkt, spätestens jedoch am fünften Werktag nach der Eröffnung des Verfahrens am Erfüllungsort für einen Vertrag mit der vereinbarten Erfüllungszeit maßgeblich ist. Treffen die Parteien keine Vereinbarung, ist der zweite Werktag nach der Eröffnung des Verfahrens maßgebend. Der andere Teil kann eine solche Forderung nur als Insolvenzgläubiger geltend machen.'

a performance date that falls after the declaration of insolvency. The performance of such transactions can, on the basis of § 104, no longer be claimed. This provision leaves room only for claims for non-performance. § 104 of the Insolvency Statute has been amended in the course of the implementation of the Collateral Directive. Section 2(6) of § 104 of the Insolvency Statute now makes clear that the provision also applies to transactions with financial collateral.

At what moment should obligations under financial collateral arrangements be valued? In this respect, the approach under German law differs from that in the Netherlands. The starting point is the same. Upon default German law also aims at immediate clarity in establishing the value of concluded transactions, and is intended to prevent speculation after the moment of insolvency. However, unlike in the Netherlands, German law traditionally allowed a maximum two-day period for valuation. The goal of this two-day period was to give the solvent counterparty an opportunity to conclude a replacement transaction (*Deckungsgeschäft*). The price of this replacement transaction could then be used for calculating the actual value of the claim for non-performance.⁸⁶ In the course of the implementation of the Collateral Directive, the German legislator has revised this two-day rule, arguing that the two-day period is not in line with modern practice, in which replacement transactions can often be concluded on the same day. One would have expected that this observation would have led to a limitation of the time frame for the conclusion of replacement transactions. The contrary, however, has occurred. The law implementing the Collateral Directive revised § 104(3) of the Insolvency Statute and allows the parties to agree upon valuation within a time frame of five days after the declaration of insolvency. This widening of the time frame coincides with the time frame laid down in the GMRA and the GMSLA (see above), and – as Löber rightly notes – with a similar five-day valuation period envisaged in the EMA⁸⁷. But the arguments for the extension of the two-day period to a period of five days have not been made clear. The only statement by the German legislator in this respect is that 'the parties may have an interest in valuation at a later moment'. What this 'interest' may be has not been explained. One drawback to a time period of five days is that it leaves room for speculation, or even manipulation at the risk of the other creditors of the insolvent estate. In line with the new text of § 104(3) of the Insolvency Statute, if the parties

⁸⁶ See the January 2004 version of § 104(3) of the Insolvency Statute.

⁸⁷ See Löber 2005, p. 77 and footnote 28. See also the definition of 'Quotation Date' in Section 7(1)(a) of the EMA.

have not agreed upon a moment of valuation, the old two-day term applies.⁸⁸

3.5.7 *Comparison with pledge law*

In the case of a right of pledge, enforcement and valuation customarily take place at a moment later than that of the declaration of insolvency. This is not objectionable because in this case there are objective mechanisms in place that guarantee that no improper speculation at the cost of the insolvent estate occurs, such as a public sale, or the intervention of a judge or – in the case of securities – of a professional intermediary. The enforcement in line with these mechanisms requires a certain period of time. In the case of set-off, objective mechanisms that guarantee a fair value are absent. Valuation is, in this case, typically a matter for the parties. It is probably for this reason that the fixation principle plays a more important role in the case of set-off than in the case of the realisation of a right of pledge. The less the difference in time between the declaration of insolvency and the moment at which the obligations subject to set-off are valued, the less the risk that other creditors are prejudiced. This also limits the risk of actions on the basis of, for example, voidable preference (cf. section 3.4 above).⁸⁹

3.5.8 *Concluding remark*

It is submitted that the moment at which the obligations that are subject to close-out netting are valued should be as close to the declaration of insolvency as possible. Deviations from this point in time are not compatible with the fixation principle, which applies in insolvency and protects the interests of the different creditors involved. This, of course, is particularly true for agreements that are clearly to the detriment of the other creditors of the insolvent estate. Nevertheless, a good reason for

88 See *Gesetzentwurf der Bundesregierung; Entwurf eines Gesetzes zur Umsetzung der Richtlinie 2002/47/EG vom 6. Juni 2002 über Finanzsicherheiten und zur Änderung des Hypothekendarlehenbankgesetzes und anderer Gesetze*, Bundesrat, Drucksache 563/03, 15 August 2003, pp. 17-19 ('Zu Nummer 4'). Idem: *Gesetzentwurf der Bundesregierung; Entwurf eines Gesetzes zur Umsetzung der Richtlinie 2002/47/EG vom 6. Juni 2002 über Finanzsicherheiten und zur Änderung des Hypothekendarlehenbankgesetzes und anderer Gesetze*, Deutscher Bundestag, Drucksache 15/1853, 29 October 2003, pp. 14-15 ('Zu Nummer 4').

89 See also Faber 2005, nos. 423-424, who is of the more liberal view that, as in the case of the execution of a right of pledge, the fixation principle plays no role when determining the moment when the determination of the value of the claims that are subject to set-off will take place.

allowing a time frame for valuation is that replacement transactions entered into immediately after insolvency can demonstrate the actual value of the claims involved. In the market as it functions today, it appears that such transactions can usually be concluded within a limited period of time, even within a day. When different time zones are involved, a longer period of e.g. two business days for valuation may be appropriate. The five-day period envisaged in the GMRA and the GMSLA and in § 104 of the German Insolvency Statute, however, seems to be too long, whereas the Dutch approach of valuation at the moment of the declaration of insolvency could be loosened somewhat in order to give the solvent party some time to enter into a replacement transaction.

3.6 Conclusion

The key point made in this section on close-out netting is that, even if Article 7 of the Collateral Directive may seem to set out a liberal and uniform regime in respect of close-out netting, national law still plays a crucial role in this field. This is partly because recital 15 of the directive, which became a part thereof at a late stage of the legislative process, refers to national law. It does so explicitly in relation to the reciprocity or mutuality requirement (see section 3.2) and national rules of voidable preference (section 3.4). But recital 15 is formulated in general terms, which arguably also bring issues such as the requirement of similarity or commensurability once again within the scope of national law (see section 3.3). Another factor that contributes to a continuing role of national law where close-out netting is concerned is that the Collateral Directive has simply not regulated certain issues. An example of this category is the moment at which mutual claims should be valued (see section 3.5). Therefore, if further convergence in respect of the treatment of close-out netting arrangements is desired on a European level, the issue should be read-dressed.⁹⁰

90 Note that the European Financial Market Lawyers Group has proposed a number of further liberalisations in the field of insolvency set-off and netting agreements in the EFMLG Report (2004). It has done so in light of the importance of set-off and netting arrangements for financial market participants. The EFMLG Report (2004), however, pays no attention to the issue of the continuing role of national law in this field, and neglects the fact that set-off or netting by one creditor also has a detrimental effect on the position of other creditors.

4. THE DECLARATION OF INSOLVENCY: NO RETROACTIVE EFFECT, ENFORCEABILITY OF LEGAL ACTS

4.1 Starting point: retroactive effect, no enforceability of legal acts

Under the Dutch Bankruptcy Code, a declaration of insolvency is, as a rule, applied retroactively. An insolvency takes effect at the beginning of the day of such a declaration. This rule is sometimes referred to as the 'zero hour rule'.⁹¹ A related principle is that from that moment onwards, the insolvent party himself can no longer bind the insolvent estate by disposing of the assets that fall within the insolvent estate, while also other legal acts carried out after that moment without the consent of the insolvency administrator are, as a rule, not enforceable against the insolvent estate.⁹² Like the earlier Settlement Finality Directive, the Collateral Directive thwarts these two principles. Article 8(1)(a) of the Collateral Directive determines that the declaration of insolvency may not have retroactive effect where transactions with financial collateral are concerned. Article 8(2) of the Collateral Directive, under certain circumstances, does leave room for creditors under a financial collateral arrangement to invoke the enforceability of legal acts entered into after the declaration of insolvency.⁹³

4.2 The declaration of insolvency has no retroactive effect

Article 8(1)(a) of the Collateral Directive requires the abolition of the retroactive effect of the declaration of insolvency.⁹⁴ This provision has been implemented in the Netherlands by adding Article 63e, first paragraph, to the NBC.⁹⁵ This provision reads as follows:

As a deviation from Articles 23 and 35 the declaration of the insolvency of a debtor under a financial collateral arrangement in the sense of Article 51 of Book 7 of the Civil Code does not have retroactive effect extending to the beginning of the day on which that declaration is issued, in relation to a financial collateral agreement

⁹¹ See Articles 23 and 35 of the NBC.

⁹² This follows from Articles 23, 24, 35, 53(1) and 54(2) of the NBC and from the fixation principle that applies in insolvency. Article 24 of the NBC contains an exception: legal acts are enforceable if they are beneficial to the insolvent estate.

⁹³ On the different provisions of the NBC that may conflict with the arrangements covered by the Settlement Finality Directive and the Collateral Directive see Van Setten in Vereecken / Nijenhuis 2003, pp. 258-261.

⁹⁴ For the text of this provision see section 8.8.2 of chapter II or Appendix 2.

⁹⁵ In the original, but rejected, draft proposal with number 28 874 Article 63e of the NBC was numbered as 63c.

concluded before the moment of the declaration of insolvency, or a transfer, the establishment of a right of pledge or a netting order on the basis thereof ⁹⁶

This digression from the principle that the declaration of insolvency has retroactive effect has the following consequence. Suppose an insolvent party fulfils an obligation under a financial collateral agreement to transfer money or securities to his counterparty on the day of the declaration of insolvency, but before the moment when the insolvency is actually declared. Before the implementation of the Collateral Directive the administrator of the insolvent estate could reclaim the money or securities transferred on the basis of Article 23 NBC. Under the Collateral Directive this is different. The financial collateral cannot be reclaimed for the benefit of the insolvent estate.

Earlier, Articles 3, 6(1) and 7 of the Settlement Finality Directive set out a comparable exception for systems in which orders for the transfer of money or securities are settled ('settlement systems').⁹⁷ Transfer orders and netting in settlement systems are enforceable until the actual moment of the commencement of insolvency proceedings. Whereas the Settlement Finality Directive is intended to guarantee the uninterrupted functioning of these settlement systems, the Collateral Directive is intended to safeguard the continuity of a larger system, i.e. that of the money and securities markets. It should not be possible to reverse legal acts that have been carried out before the declaration of insolvency, as this would mean a disruption. If legal acts do not have to be reversed, money and securities continue to be available on the markets and can be used to fulfil any obligations due, even if one market participant is in trouble. A possible snowball effect in respect of the positions of other market participants is prevented. This means a limitation of the so-called systemic risk.

The approach of Article 8(1)(a) of the Collateral Directive is not advantageous to the insolvent estate. Still, there are good arguments in favour of this approach in addition to the argument of a limitation of systemic

96 Translation TK Original Dutch text 'In afwijking van de artikelen 23 en 35 werkt de faillietverklaring van een schuldenaar uit hoofde van een financieelzekerheids-overeenkomst als bedoeld in artikel 51 van Boek 7 van het Burgerlijk Wetboek niet terug tot aan het begin van de dag waarop zij wordt uitgesproken, ten aanzien van een door de schuldenaar voor het tijdstip van faillietverklaring gesloten financieelzekerheids-overeenkomst of een overdracht, vestiging van een pandrecht of een opdracht tot verrekening op grond daarvan'

97 This provision has been implemented in Dutch law by Article 212b(1) of the NBC in relation to bankruptcy proceedings

risk. It must be kept in mind that the retroactive effect of Article 23 of the NBC has mainly been introduced for reasons of evidence. At the end of the nineteenth century, the legislator reasoned that it was generally not a problem to determine the day on which transactions take place and on which the judge issues a declaration of insolvency. This was not true, however, for the exact moment (the hour and the minute) thereof. According to the legislator, it would have been difficult to determine exactly which of the transactions concluded on the day of the declaration of insolvency fell before or after the moment of the declaration of insolvency. For this reason, this declaration had retroactive effect.⁹⁸ In today's financial markets, however, it is generally easy to determine the moment at which transactions actually take place. In these markets, there is therefore no longer any sufficient reason to apply the declaration of insolvency retroactively. It is not sufficient, however, to abolish the retroactive effect of the declaration of insolvency, as is done in Article 63e, first paragraph, of the NBC. Judges should also be obligated to state in the declaration of insolvency the exact time at which it is issued, to which end Article 14 of the NBC has been revised by the Dutch law implementing the Collateral Directive. Article 14 of the NBC now obliges a judge in all cases to indicate the exact moment (the hour and the minute) of the declaration of insolvency.⁹⁹

In principle, it is sound practice that the consequences of an insolvency become effective and that fixation takes place at the moment when the declaration of insolvency is issued. Van Hees has argued that, in principle, parties should be able to rely on the enforceability of legal acts carried out before the declaration of insolvency. In the current economy, it is possible to determine exactly when a growing number of transactions are actually entered into. Van Hees has therefore proposed the abolition of the retroactive effect of the declaration of insolvency altogether.¹⁰⁰ Likewise, Verstijlen has argued for the abolition of the retroactive effect of the declaration of insolvency in all cases. In his view the insolvent's counterparty, who invokes the enforceability of legal acts, has the burden of proving

98 See the History of the NBC (2-I), p. 360

99 On the revision of Article 14 of the NBC see the Explanatory Comments (*Memorie van Toelichting*), *Tweede Kamer*, 2002-2003, 28 874, no. 3, pp. 19-20, *Tweede Kamer*, 2004-2005, 30 138, no. 3, p. 21. As a result of the implementation of the earlier Settlement Finality Directive, Article 212b(5) of the NBC already set out an obligation for the judge to indicate exactly when an entity falling within the scope of this directive is declared bankrupt. This provision has been rescinded with the implementation of the Collateral Directive and the revision of Article 14 of the NBC.

100 See Van Hees 2000, pp. 132-135

that these legal acts were carried out before the declaration of insolvency.¹⁰¹

4.3 Enforceability of legal acts after the declaration of insolvency

4.3.1 Introduction

Are legal acts that have an effect on the insolvent estate enforceable if they have been concluded after the declaration of insolvency and without the consent of the insolvency administrator? As a principle of Dutch law this is not the case. This means that a financial collateral agreement or a transaction concluded after the declaration of insolvency, or payments to or by the insolvent party without the consent of the insolvency administrator, cannot be invoked against the insolvent estate. The Collateral Directive and the Dutch implementing law, however, make an exception to this principle. Under certain conditions, Article 8(2) of the Collateral Directive makes it possible for the counterparty of an insolvent party in a financial collateral arrangement to invoke protection even after the declaration of insolvency.¹⁰² The Dutch implementing provision is Article 63e, second paragraph, of the NBC, which reads as follows:

Articles 23, 24, 35, 53(1), 54(2) of this code [i.e. the Bankruptcy Code, TK], as well as Article 72, opening words and subsection a, of Book 3 of the Civil Code cannot be invoked against third parties in relation to a financial collateral agreement in the sense of Article 51 of Book 7 of the Civil Code that is concluded after the declaration of insolvency, in relation to the transfer or establishment of a right of pledge on the basis of a financial collateral agreement, as well as in relation to all legal acts based on a financial collateral agreement in connection with obligations of the debtor that have come into existence after the declaration of insolvency, if the legal act concerned takes place on the day of the declaration of insolvency and if the counterparty can prove that he did not know and should not have known of the declaration of insolvency at the time of the legal act¹⁰³

101 See Verstijlen 2005, section 6

102 For the text of this provision see section 8.8.3 of chapter II or Appendix 2

103 Translation TK Original Dutch text 'De artikelen 23, 24, 35, 53, eerste lid, 54, tweede lid, van deze wet, alsmede artikel 72, aanhef en onder a, van Boek 3 van het Burgerlijk Wetboek, kunnen niet aan derden worden tegengeworpen ten aanzien van een door een schuldenaar na het tijdstip van faillietverklaring gesloten financieelzekerheidsovereenkomst als bedoeld in artikel 51 van Boek 7 van het Burgerlijk Wetboek, een overdracht of vestiging van een pandrecht op grond van een financieelzekerheidsovereenkomst, alsmede elke rechtshandeling op grond van een financieelzekerheidsovereenkomst vanwege verbintenissen van de schuldenaar die na het tijdstip van faillietverklaring zijn ontstaan, mits de betreffende rechtshandeling plaatsvindt op de dag van faillietverklaring en de wederpartij kan aantonen

In accordance with this provision, legal acts entered into after the declaration of insolvency are enforceable if the legal act concerned takes place on the day of, but after the moment of, the declaration of insolvency, and if the insolvent party's counterparty was not aware, nor should have been aware of the insolvency. This means that the insolvent party can successfully effectuate, for example, margin or income payments after the moment of the declaration of insolvency, but on that same day, to a third party in 'good faith'. The money or securities transferred disappear out of the insolvent estate and are no longer available to the joint creditors of the estate.

4.3.2 *General principle and four exceptions*

Under Dutch law, in principle, legal acts conducted by the insolvent party after the declaration of insolvency cannot be enforced against the insolvent estate. This means, for example, that a creditor of the insolvent estate cannot receive payments or other rights from the insolvent entity at the cost of the insolvent estate without the co-operation of the insolvency administrator. It also means that a debtor of the insolvent entity can, in principle, only make liberating payments to the insolvent estate, and not to the insolvent entity in private. As a rule, the counterparties of the insolvent entity cannot invoke protective provisions from the moment when the insolvency is actually declared by a judge. This approach is intended to protect the interests of all other creditors of the estate. Over time, however, four exceptions to the principle that individual counterparties of the insolvent entity are not protected have become part of the NBC.¹⁰⁴

1. The first exception is laid down in Article 52 of the NBC. Essentially, Article 52 of the NBC determines that a liberating payment can be made to the insolvent party in person, if the party who made the payment did not know about the declaration of insolvency. This provision has been in force since 1896. The content of this provision is as follows:

dat deze ten tijde van de rechtshandeling de faillietverklaring niet kende of behoort te kennen.'

104 See Verschoof 1992, chapters 7 and 8; Polak-Wessels II, no. 2245-2247; Van Hees 1996. In addition to the exceptions discussed below, Van Hees 1996 points out that the protection of parties who obtain immovable assets from an insolvent party is extended under the current Dutch Civil Code. On this issue, see also Verschoof 1992, p. 14. This exception concerning immovable assets is not discussed further in this study.

1. Payment to the bankrupt after the declaration of bankruptcy but before its publication in the performance of obligations owed to the bankrupt and arising before the declaration of bankruptcy will discharge the payor as against the estate provided it is not proved that he knew of the declaration of bankruptcy.

2. A payment referred to in the preceding paragraph made to the bankrupt after publication of the declaration of bankruptcy will only discharge the payor as against the estate if he proves that the declaration of bankruptcy could not have been known at the time by legal publication in his place of residence, subject to the right of the *curator* to prove that it was known to him nevertheless.

3. Payment to the bankrupt will in any case discharge the debtor from liability to the estate insofar as his payment accrues to the estate.¹⁰⁵

2. A second exception to the principle that legal acts conducted after the declaration of insolvency are not enforceable is laid down in Article 35(3) of the NBC, which came into force in 1992, together with Books 3, 5 and 6 of the NCC. The text of this provision reads as follows:

For the application of articles 86 and 238 of Book 3 of the Civil Code a person acquiring from the debtor is deemed to have been aware of the debtor's lack of legal capacity after the publication of the bankruptcy order referred to in the third paragraph of article 14.¹⁰⁶

This new provision envisages a role for Articles 3:86 and 3:238 of the NCC in insolvency. On the basis of these provisions, the party who obtains a movable asset or a right to bearer or order (*recht aan toonder of order*), or a possessory right of pledge in respect of such assets from a party without legal capacity (such as an insolvent party), can under certain circum-

105 Translation: Netherlands Business Legislation. Original Dutch text: '1. Voldoening na de faillietverklaring doch vóór de bekendmaking daarvan, aan den gefailleerde gedaan, tot nakoming van verbintenissen jegens dezen vóór de faillietverklaring ontstaan, bevrijdt hem, die haar deed, tegenover den boedel, zoolang zijne bekendheid met de faillietverklaring niet bewezen wordt.

2. Voldoening, als in het vorig lid bedoeld, na de bekendmaking der faillietverklaring aan den gefailleerde gedaan, bevrijdt tegenover den boedel alleen dan, wanneer hij, die haar deed, bewijst dat de faillietverklaring te zijner woonplaats langs den weg der wettelijke aankondiging nog niet bekend kon zijn, behoudens het recht van den curator om aan te toonen, dat zij hem toch bekend was.

3. In elk geval bevrijdt voldoening aan den gefailleerde den schuldenaar tegenover den boedel, voor zooverre hetgeen door hem voldaan werd ten bate van den boedel is gekomen.'

106 Translation: Netherlands Business Legislation. Original Dutch text: 'Voor de toepassing van de artikelen 86 en 238 van Boek 3 van het Burgerlijk Wetboek wordt degene die van de schuldenaar heeft verkregen, geacht na de bekendmaking van de faillietverklaring, bedoeld in artikel 14, derde lid, diens onbevoegdheid te hebben gekend.'

stances, invoke the enforceability of these legal acts. An important criterion to determine the success or failure of this appeal is knowledge of the declaration of insolvency. Article 35(3) of the NBC determines that the insolvent party's counterparty is deemed not to have known about the declaration of insolvency until the moment it is published in the *Nederlandsche Staatscourant* in accordance with Article 14(3) of the NBC.¹⁰⁷ In the period between the declaration of insolvency and the publication thereof in the *Nederlandsche Staatscourant*, the insolvent party's counterparty is therefore deemed to be acting in 'good faith'.¹⁰⁸

The Dutch legislator has introduced this provision on the basis of the *Van der Hoeven q.q. / Gemeente Amsterdam* decision of the Supreme Court¹⁰⁹. The legislator has perceived this decision of the Supreme Court as a general rule on the protection of individual creditors. This rule determines that a transferee or a pledgee who has obtained a right from his insolvent counterparty is deemed to be acting in good faith (i.e. he did not know and should not have known about the insolvency) and can invoke protective provisions from the moment of the declaration of insolvency until the publication thereof in the *Nederlandsche Staatscourant* or a newspaper in line with the version of Article 14(3) of the NBC in force at that time.¹¹⁰ To a large extent, this interpretation seems to have been derived from the following passage from the *Van der Hoeven* decision:

In line with the provisions of the Bankruptcy Code and the Civil Code, an insolvency administrator can always reclaim an asset from a pledgee, to whom this asset was pledged by the insolvent party without notification to the insolvency administrator, and who has taken possession of the pledged asset after the publication of the insolvency decision, without being under an obligation to pay any compensation to the pledgee¹¹¹

107 Until a revision of the NBC that took effect on 15 January 2005 (see *Staatsblad* 2004, 615, *Staatsblad* 2005, 10), Article 14(3) of the NBC also required the publication of the declaration of insolvency in one or more newspapers designated by the insolvency judge (*rechter-commissaris*)

108 On the practical meaning of Article 35(3) of the NBC for the establishment of a valid right of pledge see Pitlo, Reehuis / Heisterkamp 2001, sections 773 and 800

109 See Supreme Court, 18 April 1947, *Nederlandsche Jurisprudentie* 1948, no 447

110 See footnote 107 above

111 Translation TK. Original Dutch text 'dat, volgens de bepalingen van de F W en van het B W, de curator een tot den faillieten boedel behoorenden zaak, welke de gefailleerde buiten zijn voorkennis heeft verpand, van den pandhouder, die deze zaak na de openbaarmaking van het vonnis van faillietverklaring in pand heeft genomen, steeds kan terugvorderen, zonder tot eenige vergoeding gehouden te zijn'

It is, however, disputed whether the Supreme Court actually intended to formulate such a rule. The *Van der Hoeven* decision did not relate to the twilight zone between the declaration of insolvency and the publication thereof in the *Nederlandsche Staatscourant* or a newspaper, but concerned a right of pledge that was vested approximately three weeks after the pledgor was declared insolvent by the court. The Supreme Court simply did not have to decide on the specific issue of exactly what moment of 'publication' is decisive for the protection of individual creditors: the issuance of the insolvency order by the judge in public (Article 1 of the NBC), the publication thereof in the *Nederlandsche Staatscourant* or a newspaper (Article 14(3) of the NBC), or in the insolvency register (Article 19 of the NBC)¹¹². That the decision does not deviate from the general principle of Dutch insolvency law, i.e. no protection of individual creditors as of the moment of the issuance of the court order in public by a judge, is a position easily defended. This latter interpretation would be in line with the Supreme Court's 1980 *ABC* decision.¹¹³ This decision rejected a plea invoking a general principle of protection for individual creditors (Article 35(3) of the NBC was at that time not in force and could not be invoked), which would apply until the publication of the declaration of insolvency in a periodical, i.e. also after the declaration of insolvency by the judge.

In any case, Article 35(3) of the NBC is not in accordance with the general principle of Dutch insolvency law that the interests of the joint creditors prevail over the interests of individual creditors.¹¹⁴

3. A third exception to the principle of insolvency law, which states that the joint interests of the creditors of the insolvent estate prevail over the interests of individual creditors, derives from Article 3 of the Settlement Finality Directive. This provision has been implemented into Dutch law by Article 212b(3) of the NBC¹¹⁵ in relation to bankruptcy proceedings. Article 212b(3) of the NBC basically states that an order given to a

112 In 2005 an online register has been established, which contains information on insolvencies as of 1 January 2005. See <http://insolventies.rechtspraak.nl>.

113 See the *ABC / Emmerig q.q.* case, Supreme Court, 11 January 1980, *Nederlandse Jurisprudentie* 1980, no. 563.

114 See the excellent conclusion of Advocate-General Franx in the *ABC / Emmerig q.q.* case, as well as the authors mentioned in that conclusion. See also the History of the NBC (2-III), pp. 83-85, and the literature both for and against the legislator's interpretation of the *Van der Hoeven* decision mentioned therein. See also Verschoof 1992, pp. 13-14.

115 This provision was numbered 212b(2) until a revision of the NBC that took effect on the 15 January 2005 (see *Staatsblad* 2004, 615; *Staatsblad* 2005, 10).

settlement system by a participant to such a system can be carried out that same day, even if it is given after that participant has been declared insolvent. The party who settles such an order must act in good faith. This provision implementing the Settlement Finality Directive became part of Dutch law on 1 January 1999.

4. As was mentioned in the above introduction, the fourth exception to the rule that counterparties of an insolvent entity cannot invoke protection after the declaration of insolvency has been laid down in Article 63e, second paragraph, of the NBC as a result of the implementation of the Collateral Directive in 2006. This provision is relevant for legal acts in relation to financial collateral after the declaration of insolvency, such as a transfer or the establishment of a security interest in respect thereof. It entails a further erosion of the principle that no protection can be invoked after the declaration of insolvency. Verstijlen has noted that Article 63e, second paragraph, of the NBC leads to an inconsistent system of insolvency law and that there are no good arguments why a creditor under a financial collateral arrangement should be put in a better position than other creditors.¹¹⁶ This is also my opinion.¹¹⁷ Verstijlen's suggestion to eliminate these inconsistencies by extending the protection for creditors under a financial collateral arrangement to other creditors as well, should, however, not be followed.¹¹⁸ This would be to the detriment of all the creditors who do not happen to receive payments from the insolvent entity and would further undermine the *pari passu* principle. It would be better to reconsider Article 8(2) of the Collateral Directive and to determine under what circumstances a deviation from the *pari passu* principle can indeed be justified.¹¹⁹

If none of these exceptions applies, the general rule of Dutch insolvency law must be followed, which means that no protection can be invoked after the declaration of insolvency.

116 See Verstijlen 2005, section 6.

117 See Keijser 2003 I, sections 3 and 7; Keijser 2004, section 6.

118 See Verstijlen 2005, section 7.

119 On this issue, see also section 4.5 of chapter VI.

4.3.3 Pros and cons

a. Systemic risk

The key argument used to justify the rule that legal acts are under certain circumstances enforceable even after the declaration of insolvency is the need to eliminate systemic risk. The counterparty of an insolvent entity in a system or under a collateral arrangement must be sure that payments of cash or transfers of securities cannot be reversed, even if they have been carried out after this moment in time. Otherwise, this may result in a default by that insolvent entity's counterparty, possible contagion effects on other market participants, and thus systemic risk.

How convincing is this argument? The rule seems to be relevant in only a limited number of cases. Vereecken presents two examples of a financial institution that transfers assets after a declaration of insolvency. He mentions a foreign branch of a financial institution, which transfers assets not knowing that the institution has been declared insolvent according to the laws of another jurisdiction. He also shows that a financial institution may carry out transactions both in the name of and for the account of another institution that has, in the meantime, been declared insolvent.¹²⁰ These are exceptional cases, which may, of course, cause inconvenience, but which can hardly be deemed to pose a systemic risk to the entire financial sector. It should be taken into account that in the financial markets, information about a (forthcoming) declaration of insolvency is generally made available immediately, for instance by supervisors or rating agencies. This circumstance not only makes legal acts by a (foreign) branch or on the basis of a power of attorney unlikely, but also makes it difficult for the insolvent entity's counterparty to invoke 'good faith'.

In the case of transactions involving small and medium-sized enterprises, such information is less readily available. But even here legal acts entered into after the declaration of insolvency can hardly be considered a trigger to systemic risk. As a result of the size of transactions entered into by small and medium-sized enterprises, their non-enforceability is unlikely to cause contagion effects and pose a danger to the entire financial sector. Like in the case of the Collateral Directive's right of use or its liberal enforcement regime, in the case of legal acts entered into after the declaration of insolvency there is no need to harm the position of small and

120 See Vereecken / Nijenhuis 2003, pp. 46-47.

medium-sized enterprises (and their joint creditors) generally, in order to dispel the risk of a strain on liquidity that might occur only in exceptional cases.

b. Misuse and proof of good faith

Another circumstance that should be taken into account is that the rules of the directives can be misused by an insolvent entity wishing to favour a counterparty who is not yet aware, or claims not to be aware, of the declaration of insolvency. But also if, for example, an employee makes an unauthorized payment, the counterparty acting in good faith may invoke protective provisions. This is to the detriment of all other creditors. Is there a risk of such misuse in practice? Several scenarios should be considered. If an insolvent financial institution transfers assets to another financial institution after the declaration of insolvency, it is unlikely that this latter institution can invoke good faith, because, as was indicated above, information about the (forthcoming) insolvency will usually have been distributed immediately and on a wide scale by, for example, regulators and rating agencies. Only in a cross-border context may such information, in exceptional cases, not be readily available. If an insolvent financial institution favours a corporate counterparty, it is more likely that such information is less readily available, in particular where small or medium-sized enterprises are concerned. In this case it is therefore easier for such a counterparty to invoke good faith. In the event of the insolvency of an enterprise, this enterprise may make a payment in favour of its own bank. Invoking good faith will, however, prove a difficult task for that bank, because a bank is usually well informed about its client's financial position. If, however, the insolvent enterprise favours another enterprise (note that some countries in the European Union have given the Collateral Directive a scope that also includes such relationships), it will again be easier for the corporate counterparty to prove that it was acting in good faith. In particular, when an insolvent entity transfers assets to a corporate counterparty, the possibility that good faith may be successfully invoked cannot, therefore, be excluded. The consequence thereof would be that assets, which may represent a considerable value, are withdrawn from the joint creditors of the insolvent estate.

Who bears the burden of proof? In principle, the counterparty of the insolvent party must prove that he did not know and should not have known about the insolvency. This is a difficult task from the moment that information about the insolvency becomes publicly available, because in this

case, the counterparty should have known about it. In practice, however, the declaration of insolvency by a judge is hardly ever published the very same day in the automated online insolvency register¹²¹ or in the *Nederlandsche Staatscourant* in line with Article 14(3) of the NBC. This means that there is a time frame between the declaration of insolvency and the official publication thereof, in which case a lack of knowledge can be demonstrated fairly easily. During this interval of time, it should therefore as a rule be presumed that an enterprise that receives payments is acting in good faith. There is simply no way that it could have known of the insolvency in the absence of an official publication. Of course, this is different if it is plausible that the enterprise knew or should have known about the (forthcoming) insolvency by other means. But this, it seems, should be proved by the insolvency administrator. In the case of financial institutions, there are special circumstances that play a role in determining whether good faith can be invoked in respect of the time frame between the declaration of insolvency and the official publication thereof. In this case, as was mentioned above, information on a (forthcoming) declaration of insolvency is generally distributed swiftly and on a wide scale by supervisors and rating agencies, etc. When the insolvency administrator can show that such information has indeed been made available to market participants, a financial institution will struggle to successfully invoke good faith.¹²²

c. *The position of other creditors*

The Collateral Directive makes it possible for an insolvent party's counterparty in a financial collateral arrangement to successfully invoke protective provisions even after the declaration of insolvency. This means that cash and/or securities are no longer available to the other creditors of the insolvent estate. This is the same approach that was taken earlier in the Settlement Finality Directive. The rule set out in the directives, however, fails to conform to the general principle of insolvency law that legal acts conducted after the declaration of insolvency are not enforceable (i.e. the principle of fixation of the insolvent estate).¹²³ Neither is the rule of the

121 See footnote 112 above.

122 The issues of possible misuse and good faith were discussed in the course of Dutch parliamentary history. See *Eerste Kamer*, 2004-2005, 28 874, D, p. 6 and p. 9; *Eerste Kamer*, 2004-2005, 28 874, E, section 10 and section 21; and in particular also the debate in the First Chamber of Parliament on 1 March 2005, EK 17, p. 752 and pp. 761-762.

123 See e.g. the Principles of European Insolvency Law, § 3.4 ("Fixation" of position of creditors'), p. 40.

directives in line with the related *pari passu* or *paritas creditorum* rule, which is intended to protect the interests of the joint creditors of the insolvent estate against the single interest of an individual creditor.¹²⁴ This is a remarkable development. Under the Settlement Finality Directive and the Collateral Directive the interests of the joint creditors should, under certain circumstances, give way to the interest of a single creditor in a system or a financial collateral arrangement. The interests of the joint creditors can be seriously infringed by this approach. The insolvent party can now – deliberately or not – make effective payments to individual creditors of his choice even after the declaration of insolvency. These individual creditors will be protected if they (or, under the Settlement Finality Directive, the party settling the payment) have acted in good faith. This can lead to an arbitrary treatment of creditors that is detrimental to the joint creditors.

d. Concluding remark

All in all, the argument of systemic risk hardly seems to be a sufficient ground upon which to deviate from the fixation and *pari passu* principles that apply in insolvency, also if the possible misuse of the rule that envisages the enforceability of legal acts even after the declaration of insolvency is taken into account.

5. FREEZE PERIOD

5.1 Introduction

This section examines in how far a so-called freeze period is an impediment to the enforcement of a security interest in respect of financial collateral, or of close-out netting provisions in financial collateral agreements. The approach of Dutch law and that of the Collateral Directive and the Settlement Finality Directive are considered.¹²⁵

124 See e.g. the Principles of European Insolvency Law, § 12.2 ('Ranking of claims – *paritas creditorum*'), pp. 81-82.

125 On the freeze period see Verschoof 1992, chapter 3; Kortmann 1994 I; Van der Aa 1995; Verdaas 2003; Keijser 2003 I, section 4; Keijser 2004, section 6; Verstijlen 2005, section 6.1.

5.2 The Dutch freeze period

Articles 63a-c of the NBC regulate the freeze period, which can be put into effect from the moment of the declaration of insolvency. The core provision is Article 63a of the NBC, which states:

1 On the application of each interested party or on his own motion, the *rechter-commissaris* may proclaim a freeze period of two months at the most, during which each right of third parties, with the exception of the creditors of the estate (*boedel-schuldeisers*), to have recourse to property belonging to the estate or to claim property under the control of the bankrupt or the curator may only be exercised with his authorisation. The *rechter-commissaris* may extend this period once for no more than two months

2 The *rechter-commissaris* may restrict his order to certain third parties and attach conditions both to his order and to the authorisation of a third party to exercise a right to which that third party is entitled

3 If a third party sets a reasonable time period in respect of the exercise of his powers to the curator, this time period is suspended during the freeze period

4 The freeze period may also be proclaimed by the court issuing the bankruptcy order on the application of the party who applied for the bankruptcy or of the debtor. The freeze period that is proclaimed at the time of the insolvency order has effect from the day of the declaration of insolvency, including that day¹²⁶

126 The translation is based on that of the Netherlands Business Legislation, which has been amended by the author of this book in order to take into account changes to Article 63a of the NBC which are effective since 15 January 2005. Original Dutch text

1 De rechter-commissaris kan op verzoek van elke belanghebbende of ambtshalve bij schriftelijke beschikking een afkoelingsperiode afkondigen, waarin elke bevoegdheid van derden, met uitzondering van boedelschuldeisers, tot verhaal op tot de boedel behorende goederen of tot de opeising van goederen die zich in de macht van de gefailleerde of de curator bevinden, voor een periode van ten hoogste twee maanden niet dan met zijn machtiging kan worden uitgeoefend. De rechter-commissaris kan deze periode eenmaal verlengen met een periode van ten hoogste twee maanden

2 De rechter-commissaris kan zijn beschikking beperken tot bepaalde derden en voorwaarden verbinden zowel aan zijn beschikking als aan de machtiging van een derde tot uitoefening van een aan deze toekomstende bevoegdheid

3 Indien een derde ter zake van zijn bevoegdheid een redelijke termijn aan de curator stelt, wordt deze termijn geschorst tijdens de afkoelingsperiode

4 De afkoelingsperiode kan ook op verlangen van de aanvrager van het faillissement of van de schuldenaar worden afgekondigd door de rechter die de faillietverklaring uitspreekt. De afkoelingsperiode die tegelijkertijd wordt afgekondigd met de faillietverklaring heeft gevolgen vanaf de dag waarop de faillietverklaring wordt uitgesproken, die dag daaronder begrepen.

The objective of the freeze period that is envisaged in Article 63a of the NBC is to give the administrator of an insolvent entity time to determine the actual situation of the insolvent estate and whether there are any possibilities for a (partial) continuation of the enterprise, and, if this is not possible, how it should best be liquidated.¹²⁷ To this end, the freeze period prevents third parties, with the exception of the creditors of the insolvent estate (*boedelschuldeisers*)¹²⁸, from having recourse to the property belonging to the estate or to claim property under the control of the insolvent party or the insolvency judge (*rechter-commissaris*). Such recourse can only be had and claims can only be enforced with the consent of the insolvency administrator. This temporary measure is intended to serve the interests of the insolvent party, his creditors, employees and other parties involved. Under Dutch law, a freeze period may last for a period of two months with a possible extension of, at most, two additional months.

Article 63a has been in force since 1992. On 15 January 2005, this provision was amended in some technical respects (e.g. instead of a freeze period of two times one month, the maximum freeze period now lasts two times two months). In addition, Articles 63b and 63c were added to the regulation of the freeze period in January 2005. These provisions contain two clarifications of the powers of third parties during the freeze period. Article 63b of the NBC gives a pledgee of a claim the power to notify the debtor of that claim of the right of pledge during the freeze period. This means that, from the moment of notification, the pledgee is entitled to receive payments in respect of the claim.¹²⁹ These payments must, however, be kept apart with a trustee. During the freeze period, the pledgee is not allowed to have actual recourse. In addition, Article 63c of the NBC determines that the tax authorities may attach the assets of third parties that are located on the premises of the insolvent entity. This attachment cannot, however, be enforced during the freeze period. Moreover, it cannot be invoked against the real owners of the assets, if these real owners have claimed the assets from the insolvency administrator before the attachment by the tax authorities took place.

127 In its verdict of 19 December 2003 in the *Mobell / Interplan* case, *Rechtspraak van de Week* 2004/8, the Dutch Supreme Court stated that a freeze period becomes senseless after an insolvency administrator has decided to liquidate the insolvent entity. See section 3.4.4 of the verdict. This interpretation of the scope of the freeze period is unnecessarily restrictive as the administrator may, for example, need time to determine in what manner the liquidation should best take place.

128 I.e. creditors with a preferential claim that has come into existence after the declaration of insolvency.

129 See Article 3.246 of the NCC.

5.3 The Settlement Finality Directive and the Collateral Directive

Under the Collateral Directive, a freeze period may not be an obstacle for the enforcement of financial collateral. It follows from Articles 4(4)(d) and 4(5) of the Collateral Directive that it should be possible to enforce a right of pledge in respect of financial collateral immediately. These provisions state that a security financial collateral arrangement can take effect 'notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures' and that the realisation of a financial collateral arrangement may not be subject to 'any additional time period' elapsing. Likewise, Articles 7(1)(a) and 7(2) in conjunction with Article 4(4)(d) of the Collateral Directive make clear that close-out netting arrangements can also take effect without delay.¹³⁰ The enforcement of a right of pledge and close-out netting should not be hindered by a freeze period.

Earlier, Article 9 of the Settlement Finality Directive already determined that the rights of a collateral taker in the sense of that directive should not be affected by insolvency proceedings against the collateral provider. Recital 9 of the Settlement Finality Directive also underlines the importance of the enforceability of collateral. Even if formulated in somewhat general terms, the directive seems to exclude the applicability of a freeze period, which (albeit temporarily) does affect the rights of a collateral taker and does hamper the enforceability of collateral. In any case, the Dutch legislator has interpreted Article 9 of the Settlement Finality Directive in this way and has introduced Article 212b(2) of the NBC, which explicitly excludes the applicability of the freeze period to the enforcement of collateral in a 'system' in the sense of the Settlement Finality Directive.¹³¹

The reason why this approach has been taken in the Settlement Finality Directive and the Collateral Directive is that a freeze period can be considered as an obstacle to liquidity. The insolvency of one market

130 For the text of Articles 4 and 7 of the CD, see section 8.7 of chapter II or Appendix 2

131 The law implementing the Settlement Finality Directive took effect on 1 January 1999. See *Staatsblad* 1998, nos 714 and 715. The provision prohibiting the applicability of a freeze period to collateral provided in a 'system', only took effect only on 15 January 2005, together with a general revision of the freeze period, which was described in section 5.2 above. See *Staatsblad* 2004, 615 and *Staatsblad* 2005, 10. See also the Explanatory Comments (*Memorie van Toelichting*) to the new Article 212b(2) of the NBC in *Tweede Kamer*, 1999-2000, 27 244, no 3, pp 20-21.

participant should not pose a danger to the liquidity of the cash and securities markets generally. A contagion effect upon other market participants (i.e. systemic risk) should be prevented. This approach implies that the liquidity of the financial markets prevails over the interests of an insolvent entity. In the case of major market participants who have an important impact on the liquidity of the cash and securities markets, these arguments are indeed convincing. However, in the case of small and medium-sized enterprises, these arguments seem to have little meaning. In this case a freeze period has little or no impact on systemic risk.

5.4 The scope of the Dutch freeze period

Does the Collateral Directive necessitate a change to Articles 63a-c of the NBC? In order to answer this question, the exact scope of the freeze period under Dutch law should be examined. This section investigates in what cases the Dutch freeze period applies and, in particular, whether it applies to transactions involving financial collateral. Where transactions with financial collateral are concerned, it is important to determine whether the freeze period affects the enforcement of a security interest in respect of such collateral and of close-out netting provisions.

It should be noted from the outset that there is a considerable degree of uncertainty about the exact scope of the freeze period under Dutch law. As is shown below, this is, to a large extent, because the Dutch legislator is inconsistent in his approach to the freeze period.

The text of Article 63a suggests that the freeze period has a wide scope of applicability. It relates to 'property' (*goederen*) generally belonging to the insolvent estate or under the control of the insolvent entity or the insolvency administrator. 'Property' is a very broad notion that includes things (tangible assets) and patrimonial rights (including intangible assets, e.g. claims).¹³²

The 1992 Explanatory Comments (*Memorie van Toelichting*) to Article 63a of the NBC, however, seem to contain a limitation. By way of an example, the Explanatory Comments mention the following creditors to whom the freeze period applies: pledgees and mortgagees; creditors who have reserved title (*eigendomsvoorbehoud*), who have a right to reclaim unpaid goods (*reclamerecht*), or a right accruing from a lease; creditors who have

132 See in particular Articles 3:1-3 and 3:6 of the NCC.

otherwise given a right to make use of assets; and tax authorities in relation to their right of seizure (*bodembeslag*).¹³³ Even though this enumeration is not exhaustive, it relates in all cases to tangible assets. For this reason, Kortmann is also inclined to interpret the freeze period restrictively and to apply it to tangible assets only.¹³⁴ Van der Aa has argued that the freeze period was introduced in particular to bring to an end the practice of creditors who have reserved title collecting assets with large vehicles immediately after the commencement of insolvency.¹³⁵ This is an additional argument for a limitation of the freeze period to tangible things. It is therefore undisputed that the freeze period relates to tangible assets that are necessary for conducting an enterprise, such as machinery. But goods that are liquid and more easily replaceable, such as all kinds of goods in stock, also fall within the scope of the freeze period.

It is, nonetheless, less certain whether the freeze period also extends to intangible assets. Examples of such assets are registered claims (*vorderingen op naam*), such as rights in respect of cash, and rights relating to securities (i.e. financial collateral). After the revision of the freeze period that took effect in 2005, it is nonetheless likely that intangible assets also fall within the scope of the freeze period. The Explanatory Comments relating to the 2005 revision make it clear that the scope of the freeze period is not limited to tangible assets.¹³⁶ Section 21 of the Explanatory Comments indicates that the freeze period applies to the enforcement of all rights that influence the size and the contents of the insolvent estate. Section 44 of the comments mentions explicitly that the freeze period does not only apply to 'things', but to all property, including patrimonial rights (e.g. registered claims). Moreover, Article 63b of the NBC regulates the powers of a pledgee with a right in respect of a claim. This regulation would have been superfluous if claims fell outside the scope of the freeze period altogether.¹³⁷ The same is true for Article 212b(2) of the NBC, a provision which excludes the applicability of the freeze period to financial collateral provided in a 'system' in the sense of the Settlement Finality Directive.¹³⁸

133 See *Tweede Kamer*, 1980-1981, 16 593, no 3, pp 153-154

134 See Kortmann 1994 I, in particular section 2

135 See Van der Aa 1995, section 2

136 See *Tweede Kamer*, 1999-2000, 27 244, no 3

137 See, in this sense, also Verstijlen 2005, section 6 1

138 See section 5 3 above

If claims do indeed fall within the scope of the freeze period, this means that a right of pledge in respect of a claim cannot be immediately enforced. Indeed, as was mentioned above, Article 63b of the NBC allows the pledgee to receive payments on the pledged claim, but prohibits enforcement. Does the inclusion of claims in the scope of the freeze period also have a consequence for netting arrangements? Netting also has an effect on the insolvent estate, and could, as such, fall within the scope of Article 63a of the NBC. Before the revision of the freeze period that took effect in 2005, Kortmann argued that netting should not be hampered by a freeze period.¹³⁹ Faber, too, is not in favour of application of the freeze period to set-off.¹⁴⁰ In his view, there is no good reason to prevent the set-off of claims in insolvency. Both authors also show, however, that the scope of the freeze period is not entirely clear and that it could also be argued that netting does fall within its scope and cannot be carried out during the freeze period. The following arguments, for example, can be presented both for and against the application of a freeze period to netting:

1. One argument in favour of a broad scope of applicability of the freeze period, including claims, is that a pledgee with a right in respect of a claim or a party who can invoke netting, may decide not to exercise his right if the insolvency administrator comes up with a feasible plan for the successful continuation of the enterprise. The freeze period gives the insolvency administrator the necessary time to make such a plan, which may please the pledgee or the party who had intended to invoke netting. On the basis of the rescue plan, secured creditors can decide whether to withdraw financial resources, or whether to support the rescue plan and not invoke their right of pledge or netting. In this scenario, financial resources, which would otherwise have disappeared from the insolvent estate, are now available for the continuation of the enterprise.

2. On the other hand, one may wonder whether the powers of financiers should be curtailed this way. In particular, the fact that cash and securities (unlike machinery, for example) are easily replaceable supports the view that such assets should not be covered by the freeze period. In the case of assets that are liquid and can easily be replaced, a financier should, in this view, have the right to net immediately, which guarantees continued liquidity during the freeze period. Upon the presentation of a

139 See Kortmann 1994 I, section 8.

140 See Faber 2005, nos. 437-438.

rescue plan by the insolvency administrator, the financier can determine whether it is feasible and whether he is willing to finance it.¹⁴¹

3. The application of the criterion, set out in the Explanatory Comments relating to the 2005 revision of the freeze period, i.e. effects on the size and the contents of the insolvent estate, heighten the likeliness that close-out netting cannot be enforced during a freeze period.

4. The exclusion of close-out netting from a freeze period would lead to a certain discrepancy with pledge law. Why should a set-off of claims be possible during a freeze period, but not the enforcement of a right of pledge in respect of a claim?

Another reason why the scope of the freeze period is not undisputed is that the legislator himself has caused further confusion in the law implementing the Collateral Directive. In the Explanatory Comments to this law, the legislator has deviated from his statements in the Explanatory Comments relating to the 2005 changes to the freeze period. The Explanatory Comments to the Dutch law implementing the Collateral Directive contain some passages on the freeze period. In these texts, the legislator explains that the freeze period is intended to apply to capital equipment, such as machinery and goods in stock, which may be necessary for the continuation of the enterprise. Other rights, such as rights in respect of financial collateral, cannot be compared with rights in respect of such capital equipment, and can therefore, in the view of the legislator, be enforced irrespective of a freeze period.¹⁴²

Verdaas has pointed out that the approach of the legislator is inconsistent and confusing.¹⁴³ Verstijlen has nonetheless concluded that, all in all, the freeze period also applies to claims.¹⁴⁴ In light of the above, it must indeed be presumed that, under Articles 63a-c of the NBC, a freeze period prevents the enforcement of a security interest in respect of financial collateral. It also cannot be entirely excluded that close-out netting provisions, like those envisaged in the GMRA or the GMSLA, are not enforceable in

141 Note that the criterion of liquidity or replacability prompts the question of whether, for example, different kinds of goods in stock fall within the scope of the freeze period.

142 See *Tweede Kamer*, 2002-2003, 28 874, no. 3, p. 14 and p. 20; *Tweede Kamer*, 2004-2005, 30 138, no. 3, p. 22.

143 See Verdaas 2003.

144 See Verstijlen 2005, section 6.1.

the event that the general Dutch legal rules relating to a freeze period apply.

5.5 Implementation into Dutch law

Article 63d of the NBC gives shape to the Collateral Directive by explicitly abolishing the freeze period where financial collateral is concerned. This provision states:

The property that is pledged on the basis of a financial collateral agreement as defined in Article 51 of Book 7 of the Civil Code, is excluded from the property mentioned in Article 63a, first paragraph.¹⁴⁵

On the basis of this provision, the freeze period is not applicable to a security interest in respect of financial collateral. Such interests can therefore be realised in the course of the freeze period.

Article 63d of the NBC relates to a security interest in respect of financial collateral only. This provision, however, is silent about the issue of close-out netting. Still, in accordance with the Collateral Directive, a freeze period may also not be an impediment to close-out netting under a title transfer financial collateral arrangement. In light of the insufficiently defined scope of the freeze period under Dutch law, one could question whether it is a good thing that the Dutch legislator has limited himself to enacting a special provision that states that security interests in respect of financial collateral are enforceable during a freeze period, but has not explicitly stated that close-out netting is enforceable notwithstanding a freeze period.

In the course of parliamentary discussion, the Dutch Minister of Justice stated that an article in the NBC, which makes it clear that close-out netting provisions in a financial collateral agreement are enforceable during a freeze period, is superfluous. The minister argued that netting does not result in the disappearance of property from the insolvent estate. It may be true that the initial transfer of financial collateral has taken place at an earlier moment in time. This financial collateral has, however, been replaced by a contractual claim for the provision of equivalent assets. This

145 Translation: TK. Original Dutch text: 'Van de goederen als bedoeld in artikel 63a, eerste lid, zijn uitgezonderd de goederen die uit hoofde van een financiële zekerheidsovereenkomst als bedoeld in artikel 51 van Boek 7 van het Burgerlijk Wetboek zijn verpand.'

contractual claim falls within the insolvent estate and is extinguished (at least in part) as a result of close-out netting. Netting therefore does indeed have the consequence that property disappears out of the insolvent estate and that the size of the estate diminishes. The position of the minister in this respect is not tenable.¹⁴⁶

Close-out netting provisions of financial collateral arrangements should, in any case, be enforceable under Dutch law if a freeze period is proclaimed. Even if this cannot be based on an explicit provision in the NBC, it follows directly from the provisions of the Collateral Directive.

The effect of the non-applicability of a freeze period to security interests and netting arrangements in respect of financial collateral is that the insolvency administrator will have to allow recourse to take place immediately in respect of cash and securities that, until that moment, have formed part of the insolvent estate.

6. CONCLUSION

This chapter has examined the consequences of the Collateral Directive on the manner of the enforcement of rights in respect of financial collateral and on insolvency law. Sections 2 and 3 have examined the way in which the enforcement of a security interest in respect of financial collateral should take place under the Collateral Directive, and a number of issues in relation to close-out netting provisions in financial collateral arrangements. Generally, the Collateral Directive seeks to eliminate obstacles to enforcement and is therefore in favour of secured parties. Sections 4 and 5 of this chapter have paid attention to the following issues of insolvency law: the abolition of the retroactive effect of the declaration of insolvency, the enforceability of legal acts after the declaration of insolvency, and the non-applicability of the freeze period. Generally, the approach of the Collateral Directive (and of the earlier Settlement Finality Directive) favours the counterparty of the insolvent party under a financial collateral arrangement, and is detrimental to all other creditors.

146 See sections 14 and 20 of the Additional Explanatory Memorandum (*Nadere Memorie van Antwoord*), *Eerste Kamer*, 2004-2005, 28 874, E. See also *Eerste Kamer*, 2003-2004, 28 874, B, p 5, *Eerste Kamer*, 2003-2004, 28 874, C, p 11, *Eerste Kamer*, 2004-2005, 28 874, D, p 7 and p 9

6.1 Enforcement

6.1.1 *Enforcement of a security interest*

On the basis of the Collateral Directive, formal requirements that are set out in pledge law (such as the public sale of pledged assets, or the intervention of a judge or, in the case of securities, of an objective intermediary) may not be applied when enforcing a security interest in financial collateral. In addition, the directive opens the possibility of abolishing the prohibition of appropriation. The drafters of a UNIDROIT Preliminary Draft Convention on Substantive Rules regarding Intermediated Securities are currently considering a comparable approach. Together, the formal requirements for enforcement and the prohibition of appropriation are intended to strike a balance between the interests of all parties involved, in particular the collateral provider, his creditors and the collateral taker. In particular, they are intended to prevent abuse and to safeguard optimum proceeds. The approach of the Collateral Directive and the UNIDROIT Draft Convention can lead to situations in which the proceeds of the enforcement are not optimal, and that are disadvantageous to the collateral provider and his creditors.

Major participants in the financial markets generally know how to look after their interests. When they contract with one another, a reasonable valuation mechanism will usually be agreed upon, because these participants are equally powerful. It is arguable that in this case the interest of the insolvent estate must give way to the interest of liquid markets for cash and securities. This is different in the case of small and medium-sized enterprises, which are far less important for the liquidity of the markets, and that may, in many cases, not be able to accurately represent their interests (and those of their creditors) when entering into transactions with a more powerful, major market participant. The Collateral Directive and the UNIDROIT Draft Convention offer only one mechanism to guarantee a fair balance between the parties, which is the possibility of giving a judge the power to determine *a posteriori* if enforcement has taken place in a commercially reasonable manner. In this respect, small and medium-sized enterprises and (in case of the UNIDROIT Draft Convention) natural persons are, however, again in a disadvantageous position, because they lack the expertise to determine whether a fair value has been realised by their counterparty and whether it is opportune to resort to the court. For these reasons, it is indeed argued that these enterprises and

natural persons should be protected and fall outside the scope of the Collateral Directive and the UNIDROIT Draft Convention.

6.1.2 *Close-out netting*

If collateral has been transferred outright, enforcement in the event of default typically takes place by way of close-out netting. If a party invokes netting against his counterparty, this means that (1) the counterparty's claim is fulfilled, and that (2) the counterclaim of the party invoking netting is extinguished (up to the amount of the lesser claim). The Collateral Directive generally favours the enforceability of contractual close-out netting provisions upon default. National law, however, still plays an important role in respect of a number of issues, such as the mutuality and similarity requirements, voidable preference and the moment of valuation.

As far as the requirement of mutuality is concerned, the Collateral Directive states explicitly that it must be determined under national law whether this requirement is an obstacle to set-off. In the Netherlands, the same is true for the requirement of similarity, because the Dutch legislator has not implemented Article 7 of the Collateral Directive. Under Dutch law, the requirements of mutuality and similarity apply in principle, but can be altered on the basis of a contract. Such contracts are enforceable in insolvency if they have 'pre-insolvency' roots. The contractual close-out netting provisions of the GMRA and GMSLA are therefore enforceable under Dutch law when the master agreement and transactions thereunder have been entered into before insolvency.

Likewise, the issue of voidable preference should, according to the Collateral Directive, be determined under the rules of national law. The same is true for the question of the moment in time at which obligations that are subject to close-out netting should be valued, because this issue has not been dealt with in the directive. As far as the moment of valuation is concerned, the fixation principle should not be applied too rigidly. Some flexibility can be useful in order to determine the actual value of mutual obligations by entering into replacement transactions, for example. But the allowed time frame for valuation should be reduced to a minimum in order to prevent speculation and fraud at the cost of the insolvent estate.

6.2 Insolvency law

The Collateral Directive has three major consequences for insolvency law: the declaration of insolvency does not have retroactive effect, under certain circumstances legal acts that have been conducted after the declaration of insolvency are enforceable, and the freeze period does not apply in the case of transactions involving financial collateral. A comparable approach in relation to these issues was already present in the Settlement Finality Directive.

Generally, the Settlement Finality Directive and the Collateral Directive favour the interests of the financial markets (that have an interest in liquidity) over the opposed interests of the insolvent estate (that, on the contrary, has fixation as a starting point in order to protect the interests of the creditors of the insolvent estate in particular).

6.2.1 *The declaration of insolvency has no retroactive effect*

Under Dutch law, the declaration of insolvency generally has retroactive effect. Under the Collateral Directive, however, the insolvency becomes effective as of the exact moment when the insolvency has been declared. Even though this change is not to the advantage of the insolvent estate, it is a sound measure that an insolvency has consequences only from the moment it is declared by a judge. The reason why the declaration of insolvency normally has retroactive effect is that at the end of the nineteenth century the Dutch legislator found that it was often difficult to prove at exactly what moment in time transactions occurred and at what time the declaration of insolvency was issued. In today's financial markets, though, it is often easily possible to determine precisely at what time a transaction has taken place. In addition, as a result of the law implementing the Collateral Directive, a judge is now obliged to mention in the declaration of insolvency at what time exactly it has been issued. Some authors have argued for the abolition of the retroactive effect of the declaration of insolvency altogether.

6.2.2 *Enforceability of legal acts after the declaration of insolvency*

Under certain circumstances, the Collateral Directive leaves room for invoking provisions that protect individual creditors who have been doing business with the insolvent party after the declaration of insolvency. Legal acts are enforceable if they have been concluded after the declaration of

insolvency but on the same day, and if the insolvent entity's counterparty can prove that he did not know and should not have known of the insolvency. This means that financial collateral may disappear from the insolvent estate even after the declaration of insolvency and without the consent of the insolvency administrator. The rule that gives individual creditors under a financial collateral arrangement the right to invoke the enforceability of legal acts even after the declaration of insolvency contradicts the *pari passu* principle. It leaves room for questionable transactions that are to the detriment of the insolvent estate.

6.2.3 *No freeze period*

Transactions that fall within the scope of the Collateral Directive are not affected by a freeze period. This means that enforcement can take place without delay, which has a negative impact on the insolvent estate. This deviation from the general rules of insolvency law is justified by the argument that a temporary freeze period hampers the liquidity of cash and securities on the financial markets, which increases systemic risk.

CONCLUSION AND RECOMMENDATIONS

1. INTRODUCTION

1.1 Introductory remarks

This study relates to financial collateral arrangements. While particular attention has been paid to repurchase and securities lending agreements, derivatives have also been discussed. These financial instruments are applied by commercial market participants and by central banks on a very large scale.

The focus of this study has been on the legal issues arising in relation to financial collateral arrangements. Particular attention has, in this respect, been paid to the Settlement Finality Directive and the Collateral Directive, both of which have a number of important consequences for national rules of property and insolvency law. Whereas both directives are meant to realise such commendable objectives as the elimination of systemic risk, the achievement of legal certainty and the promotion of a liquid European market for cash and securities, they have also led to an altered balance in the interests of collateral providers, their creditors and collateral takers, and, in insolvency, the different creditors of the insolvent estate.

This chapter contains conclusions and recommendations. Section 2 of this chapter outlines the most important conclusions of this study. It describes the consequences of the Settlement Finality Directive and the Collateral Directive in the fields of property and insolvency law. On the basis of these conclusions, sections 3 and 4 set out a number of recommendations as to how these directives should be interpreted and changed.

1.2 Overview of consequences for property and insolvency law

Section 2 provides an outline of the consequences of the Settlement Finality Directive and the Collateral Directive for national rules of property and insolvency law. It summarizes the conclusions of chapters III (on transfers of title), IV (on security interests combined with a general right of disposal) and V (on enforcement).

1.3 Restrictive or extensive interpretation?

In this book, the question of the preferred interpretation of the Collateral Directive (and of national implementing laws) has been raised a number of times.¹ Having investigated the consequences of the Collateral Directive in chapters III, IV and V, it is possible to determine whether the directive in its current form should be given a restrictive or an extensive scope of application. Section 3 examines two possible ways to limit the scope of the Collateral Directive and weighs the arguments between a restrictive and an extensive scope of application.

1.4 Recommendations for change

Section 4 questions whether the rules set out in the Settlement Finality Directive and Collateral Directive are fair to all parties involved, and whether the harmonised regime should not have been slightly different. It suggests a number of changes resulting in a slightly different regime, which meets the objectives relating to systemic risk, legal certainty and liquidity, but which, at the same time, does more justice to the divergent interests of the different participants in the financial markets.

2. THE CONSEQUENCES FOR PROPERTY AND INSOLVENCY LAW

2.1 Introduction

This section begins with an outline of the key consequences of the Collateral Directive and the Settlement Finality Directive for property and insolvency law. In order to improve liquidity, the Collateral Directive sanctions title transfers of financial collateral, introduces a security interest combined with a so-called 'right of use' (i.e. a collateral taker's general right of disposal), and contains provisions relating to the manner of enforcement of interests in financial collateral (whether provided by way of an outright transfer or on the basis of a security interest). These topics are discussed in section 2.2 below. In addition, both the Collateral Directive and the Settlement Finality Directive set out a number of provisions of insolvency law, which are discussed in section 2.3. Section 2.4 assesses whether the

1 See, for example, section 3 of chapter I; sections 8.2.5, 8.3 and 8.4 of chapter II; section 3.7 of chapter III; section 4.8 of chapter IV; and section 2 of chapter V.

directives in their current form strike a fair balance between the interests of collateral providers, their creditors and collateral takers, and, in the case of insolvency, between the different creditors of the insolvent estate.

2.2 Property law

2.2.1 Introduction

In Europe, financial collateral is customarily provided on the basis of an outright transfer of title.² An outright transfer, i.e. an unlimited transfer of all right, title and interest in respect of such collateral, enables the collateral taker to dispose of the collateral in the course of his own business. If the collateral taker requires only an object by which to secure an outstanding debt, the collateral provider can provide one by establishing a security interest in respect of financial collateral. Depending on the national legal system, this security interest can, for example, be a right of pledge or a fiduciary transfer of title.

Section 2.2.2 below begins with an overview of a number of essential features of security interests, which guarantee a balance of the interests of the different parties involved. Whether or not the Collateral Directive is in line with these features will be examined in subsections 2.2.3 ('Transfer of title') and 2.2.4 ('Security interests').

2.2.2 Core characteristics of security interests

Under Dutch and German law, security interests such as a right of pledge or a fiduciary transfer of title, commonly have the following characteristic features (many of which also occur in security interests under American and English law).

1. A secured party has a *duty of due care* in respect of the assets in which he has a security interest.

2 This occurs on the basis of market documentation for repurchase, securities lending and derivatives transactions applied in Europe, such as the Global Master Repurchase Agreement, the Global Master Securities Lending Agreement, the Margin Provisions (Part 3; English law) issued by the International Swaps and Derivatives Association, and the European Master Agreement for Financial Transactions.

2. The collateral provider generally has a *right of redemption*, which means that he regains full title to exactly the same encumbered assets if he pays the secured debt.
3. A secured party has the *right to sell* encumbered assets *upon default* by the security provider, but not under normal circumstances.
4. If a secured party *sells* the encumbered assets upon default, he must do so *in a prescribed manner*.
5. The secured party is *not allowed to appropriate* the assets upon default.
6. Should there be any *surplus value* upon enforcement and fulfilment of the secured obligation, the secured party must pay this amount *to the collateral provider*.

There are also other characteristics of a right of pledge, such as its absolute and accessory character, *droit de suite*, and the special rights of a pledgee upon default. The focus of this book, however, has been on the principles listed above, which shape the fiduciary relationship between a collateral provider, his creditors, and the collateral taker. These principles guarantee a balance between the interests of the different parties involved. They are essentially an elaboration of the core principle that parties should act in a reasonable manner towards each other. The application of the pledge principles is particularly important in a situation in which there is no equal balance of power between the provider of credit and the debtor who provides collateral. Normally, the application of these principles is mandatory, but the Collateral Directive renders them inapplicable in many ways.³

2.2.3 Transfer of title

a. Enforceability of title transfer arrangements in accordance with their terms

Article 6 of the Collateral Directive states that title transfer arrangements can take effect in accordance with their terms. This provision sanctions outright transfers of financial collateral, which enable the collateral taker to dispose of the collateral in the course of his own business. If interpreted

3 On the essential features of security interests, see also section 1.3 of chapter III.

broadly, this provision also sanctions fiduciary transfers of title, which aim to provide security and do not give the collateral taker the right to freely dispose of the collateral. Such an interpretation would, however, have negative consequences for collateral providers.

A fiduciary transfer of title is essentially a security interest. For this reason, provisions and principles of pledge law are traditionally applied by way of analogy to fiduciary transfers.⁴ Applying the rules of pledge law, such as those relating to a prescribed manner of enforcement (e.g. a public sale, or a sale involving intervention by a judge or some other objective, third party intermediary) and prohibiting appropriation, guarantees a balance between the interests of the collateral provider, his creditors and the collateral taker. The principle that, upon enforcement by the collateral taker, any surplus value should be paid to the collateral provider has the same effect. The application of these rules shapes the fiduciary relationship between the parties. These rules guarantee maximum proceeds and protect the collateral provider and his creditors against a more powerful collateral taker. The application of these principles of pledge law is particularly important when there is an unequal balance of power between the credit provider and the debtor who provides the collateral. Normally, therefore, the application of these principles is mandatory.

If Article 6 of the Collateral Directive is interpreted broadly, the parties can, however, render these principles inoperable through a contract. According to Article 6, it would be possible, for example, to agree that the collateral taker / fiduciary has the right to appropriate the encumbered assets upon default. It could also be agreed that, were he to sell these assets, he would not be obliged to do so in a predetermined manner (e.g. in public, with the consent of a judge or with the intervention of an independent professional intermediary), but rather as he deemed fit. He may also not be obliged to pay any surplus value to the collateral provider. Maximum proceeds for the benefit of the collateral provider and his other creditors are clearly not guaranteed in this scenario. In short, the

4 This is the case under (old) Dutch law, for example. To a certain extent, the same is true for current German law. Note that, from 1992, fiduciary transfers of title were prohibited under Dutch law by Article 3:84(3) of the Dutch Civil Code. This provision was interpreted by the Dutch Supreme Court (*Hoge Raad*) in the *Sogelease* case of 19 May 1995, *Nederlandse Jurisprudentie* 1996, no. 119, and in the *BTL Lease* case of 18 November 2005, www.rechtspraak.nl, LJN AT8241. Within the limits of these decisions, transfers with fiduciary features are possible. Under current Dutch law, a security interest can, in any case, be established by vesting a (public or non-public) right of pledge.

consequence of a broad interpretation of Article 6 of the Collateral Directive is that the parties can, through a contract, avoid the protective mechanisms of pledge law, which are traditionally applied by way of analogy to fiduciary transfers.

b. Close-out netting

Generally, Article 7 of the Collateral Directive sanctions the enforceability of close-out netting provisions that are commonly envisaged in title transfer financial collateral arrangements. Section 1 of this provision requires Member States to ensure 'that a close-out netting provision can take effect in accordance with its terms'. Nevertheless, some crucial issues (such as the mutuality and similarity requirements, the issue of voidable preference and the moment of valuation) still need to be determined by national law. In order to achieve convergence in the field of close-out netting on a European level, the issue should be readdressed.

2.2.4 Security interests

a. A secured party's general right of disposal

One of the most remarkable changes brought about by the Collateral Directive is set forth in Article 5. In order to enhance liquidity, this provision envisages the possibility of combining a security interest with a 'right of use', i.e. a general right of disposal for the collateral taker. To a large extent, this new approach seems to have been inspired by American law. Over the past twenty years or so, a security interest combined with an unlimited right of disposal has become common in the American securities lending and derivatives markets.

If the collateral taker exercises this right of disposal by transferring the collateral assets to a third party, for example, the collateral provider loses his (proprietary) interest in the collateral⁵, and is left with a contractual claim against the collateral taker. By exercising the right of use, the collateral taker incurs a contractual obligation to transfer equivalent assets to the collateral provider no later than at the end of the transaction. On the basis of Article 5(3) of the Collateral Directive, these equivalent assets take

5 In the European Union, interests in securities are often of a proprietary nature. See the EFMLG Report (2003). The Dutch SGT system may also be considered.

the place of the assets originally provided (i.e. a rule of proprietary substitution).

The Collateral Directive's right of use is not compatible with key characteristics of security interests. Security interests, such as a right of pledge, customarily relate to assets that can be used for purposes of recourse if a secured debt is not satisfied. Under 'normal', i.e. non-default circumstances, the encumbered assets cannot generally be used for other purposes, such as in the case of a right of usufruct, let alone be disposed of. A secured party's general right of disposal is also not in line with his duty of due care in relation to the assets in which he has a security interest. The construction conflicts with the ban on appropriating encumbered assets, which is applied in a number of Member States. Moreover, it frustrates the collateral provider's right of redemption, which means that he regains full title to exactly the same encumbered assets if he pays the secured debt. These traditional principles guarantee a balance between the interests of the collateral provider and collateral taker, which is disturbed by the Collateral Directive. The fiduciary character of a security interest, which protects the interests of collateral providers and their creditors against those of collateral takers (who are often in a stronger position), is therefore not in line with a collateral taker's general right of disposal, which is, in fact, a right to end the fiduciary relationship between the parties.

Based on an analysis of American, English, Dutch and German law, it has been submitted in chapter IV that a security interest combined with a right of use is essentially an outright transfer. Under English law, for example, a collateral taker's general right of disposal is not compatible with equitable rules, such as, in particular, the collateral provider's equity of redemption. According to the general principles of English law, a security interest combined with a 'right of use' should be characterised as an outright transfer. Under Dutch and German law, a security interest combined with a general right of disposal can best be understood by referring to the irregular right of pledge or *pignus irregulare*. The irregular right of pledge is based on the principle that ownership passes from one party to another when assets are rendered replaceable. This occurs when a non-owner (e.g. a pledgee, a usufructuary or a borrower of fungible assets) is given the right to dispose of the assets involved, and is under an obligation to return equivalent assets to the original owner. According to the right of use envisaged in the Collateral Directive, assets are essentially

made replaceable. Under general principles of law, this would result in an outright passing of title.⁶

Under the Collateral Directive, ownership arguably passes only at the moment that the right of use is exercised. It should, however, be noted that the rights of the collateral provider are already impaired in the period between the establishment of the general right of disposal and the exercise thereof. In the case of a traditional security interest, the collateral provider retains his ownership interest and redemption right, which are lost only in the event of the collateral provider's own default. If the collateral taker is granted a general right of disposal, the ownership and redemption rights are not only subject to the collateral provider's default, but also to the collateral taker's right of disposal, which can be exercised at any time, leaving the collateral provider with a contractual claim.

Friction also arises in connection with the Collateral Directive's rule of proprietary substitution, which is, to a large extent, an empty shell. Contrary to traditional rules of proprietary substitution under Dutch law, for example, the Collateral Directive's rule only relates to equivalent assets and not to other assets that might replace the original collateral assets (e.g. the sale proceeds). Moreover, it takes effect only when the collateral taker decides to transfer the equivalent assets, and not at the point at which the collateral taker becomes entitled to them. If the equivalent assets are transferred at the same time that the secured debt is paid off, as is usually the case, no proprietary substitution takes place at all. This is because, in line with the accessory character of security interests, the collateral taker's security interest ceases to exist once the secured debt is satisfied. As a result, the collateral provider is left with a contractual claim from the moment that the right of use is exercised to the moment that the collateral taker transfers equivalent assets, usually at the end of a transaction. During this period, the collateral provider runs the risk that the collateral taker will become insolvent.⁷

Combining a security interest with a right of use enhances the liquidity of the markets. However, it puts a collateral provider in an undesirable

6 For a comparable analysis in relation to Danish and Italian law, see the relevant chapters of the Right of Use Report

7 This risk is mitigated if the collateral provider can offset his right to receive equivalent assets with his obligation towards the collateral taker to fulfil the secured debt. However, when price fluctuations of the cash and/or securities concerned occur, a residual risk may remain

position, leaving him with a contractual claim against the collateral taker. Moreover, the right of use infringes upon a number of core principles of pledge law, such as the duty of due care, the prohibition of appropriation, and the right of redemption. It is not in line with the fiduciary nature of security interests. It could, therefore, be argued that for e.g. tax, accounting and capital adequacy purposes, the construction should be treated as what it essentially is, i.e. an outright transfer. In addition, it should be noted that the goal of liquidity could have been reached without blurring the distinction between outright transfers and security interests. It would have been better if the Collateral Directive had been limited to sanctioning the market standard for the provision of financial collateral, i.e. by way of an outright transfer thereof.⁸

b. Liberal enforcement regime

Article 4 of the Collateral Directive envisages a liberal regime for the enforcement of security interests, such as a right of pledge. In the event a collateral provider defaults, the collateral taker can enforce his security interest without abiding by formal requirements such as a public sale or the intervention of an impartial intermediary. Moreover, the Collateral Directive takes the non-applicability of the prohibition of appropriation as a starting point. This means that the collateral taker can, if this has been agreed to by the parties, appropriate assets upon default and value them on the basis of a contractual arrangement. The combination of mandatory enforcement procedures with the prohibition of appropriation prevented abuse and ensured maximum proceeds. As such, the interests of collateral providers and their creditors were taken into account. Under the Collateral Directive, these protective mechanisms can be rendered inapplicable on the grounds of a contract.

There is good reason to deviate from the strict rules guaranteeing maximum proceeds in the enforcement of a security interest and to depart from mandatory principles of pledge law. The liberal enforcement regime of the Collateral Directive is justified by the argument that it guarantees the continued liquidity of the cash and securities markets, and as such limits systemic risk. In addition, a reasonable valuation of collateral is likely to occur in transactions between major, equally powerful market participants. Furthermore, the Collateral Directive allows for national

8 On the collateral taker's general right of disposal, see also Johansson 2005, section 3.4.

rules that enable a judge to check *a posteriori* whether the valuation of collateral has taken place in a commercially reasonable manner. These arguments are convincing in relation to major market participants and in this case justify the Collateral Directive's liberal enforcement regime.

The Collateral Directive, however, is not fair to small and medium-sized enterprises. There is a clear imbalance of power between these players and major market participants. In addition, the impact of small and medium-sized enterprises on the overall liquidity of the cash and securities markets is limited. The liberal enforcement regime of the Collateral Directive fails to take into account their interests and those of their creditors in a satisfactory way. Optimum proceeds are not guaranteed if valuation mechanisms are determined in a contract, the terms of which may be dictated by the credit provider / collateral taker. Moreover, it may be difficult for a small or medium-sized enterprise to determine whether it is feasible to start legal proceedings against a collateral taker after enforcement has taken place, especially if it lacks expertise and direct access to accurate information on fair prices for financial collateral.⁹ The Collateral Directive should therefore not be applied to small and medium-sized enterprises.

All in all, the liberal approach of the European legislator in respect of security interests is unfortunate. It is particularly disadvantageous to small and medium-sized enterprises. The right of use usually leaves them with a contractual claim throughout the course of a transaction. Moreover, the legal mechanisms that prevent abuse and guarantee optimal proceeds are rendered inactive when a right of pledge or a fiduciary ownership right is enforced. It is also therefore regrettable that those responsible for drafting a UNIDROIT Convention on Substantive Rules regarding Intermediated Securities are currently considering a similar approach in respect of security interests in 'intermediated' (i.e. book-entry) securities. The draft UNIDROIT Convention, as a rule, even applies to natural persons and envisages an automatic general right of disposal for the secured party, i.e. one without the consent of the security provider.¹⁰ In its current form, the draft UNIDROIT Convention, like the Collateral Directive, fails to pay sufficient attention to the position of weaker economic players who

9 Securities are not necessarily listed with transparent prices on exchanges. They may, for example, be traded on alternative trading platforms or in the over-the-counter market, where prices may diverge.

10 See UNIDROIT 2006, Study LXXVIII – Doc. 42, March 2006, Appendix 2, Articles 23-27.

may be faced with a disadvantageous enforcement regime and, in the case of a right of use, a mere contractual claim against the collateral taker.

2.2.5 *Concluding remark*

One of the basic arguments of the chapters on property law is the incompatibility between the fiduciary relationship that arises in the case of a security interest and a general right of disposal. This explains why an outright transfer of financial collateral in a genuine repo or securities lending transaction that envisages both a recovery and a tradeability function, is enforceable under general principles of Dutch law, for example, and will not be recharacterised as a security interest (chapter III). The incompatibility between the fiduciary nature of a security interest and a general right of disposal also explains why a security interest combined with a 'right of use' should, with regard to content, be qualified as an outright transfer (chapter IV).

2.3 **Insolvency law**

The Settlement Finality Directive and the Collateral Directive contain a number of provisions of insolvency law which have a potentially negative impact on the size of the estate of an insolvent entity. The changes are advantageous to the insolvent entity's counterparty in a system or under a collateral arrangement, but detrimental to his other creditors.

2.3.1 *The declaration of insolvency has no retroactive effect*

The Collateral Directive, like the Settlement Finality Directive, does not recognise the retroactive effect of a court's declaration of insolvency, which is timed from the beginning of the day that the insolvency is declared (the so-called 'zero hour rule'). This means that under these directives, insolvency takes effect from the precise moment that the insolvency is declared. Money and securities paid by the insolvent party on the day of the declaration of insolvency, but before the exact moment of that declaration, therefore fall outside of the insolvent estate. While this may be disadvantageous to the insolvent estate and the insolvent entity's other creditors in those Member States in which a declaration of insolvency has retroactive effect, it is a fair rule. The Collateral Directive accurately applies the principle that fixation of the insolvent estate takes place at the moment the insolvency is declared.

2.3.2 *Enforceability of legal acts after the declaration of insolvency*

Under certain circumstances, the Settlement Finality Directive and the Collateral Directive allow the creditor under a financial collateral arrangement to invoke the enforceability of legal acts that have been entered into by the insolvent entity without the consent of the insolvency administrator and after the moment of the declaration of insolvency. This provision is not in line with the general principle in, for example, Dutch insolvency law, according to which legal acts that have been conducted after the moment of the declaration of insolvency are not enforceable. Fixation at the moment of the declaration of insolvency is intended to protect the interests of the joint creditors of the insolvent estate against those of an individual creditor invoking protective provisions. The approach of the Settlement Finality Directive and the Collateral Directive means that the insolvent estate and the joint creditors of the insolvent entity are put in a disadvantageous position compared to that of a single creditor. The European legislator has not made it sufficiently clear that this breach of the fixation and *pari passu* principles can be justified by invoking systemic risk. Legal acts conducted after a declaration of insolvency can hardly be expected to be so numerous that they cause such risk.

2.3.3 *No freeze period*

The Settlement Finality Directive and the Collateral Directive render inoperable temporary freeze periods under national insolvency law during which (secured) creditors cannot execute their rights. Consequently, for example, a credit provider who has a right of pledge in respect of financial collateral, or who wants to enforce close-out netting provisions, does not have to wait until a freeze period (which may be applicable under national law), has expired. The cash and/or securities can be released from the insolvent estate without delay. This rule may be detrimental to the insolvent estate, but it does limit systemic risk, because recourse can be had immediately.

2.4 **Who pays the price of enhanced liquidity?**

The above points to a conflict between the objectives of the Settlement Finality Directive and the Collateral Directive, on the one hand, and reaching a fair balance between the interests of different participants in the financial markets on the other. The Settlement Finality Directive and the Collateral Directive have the honourable goals of reducing systemic

risk, ensuring finality of payments, improving the liquidity of the cash and securities markets, establishing flexible methods for the provision and enforcement of collateral, and achieving legal certainty. At the same time, in their current form the directives disturb the balance that is traditionally struck between the interests of collateral providers, their creditors and collateral takers, and, in insolvency, between the different creditors of the insolvent estate.

In many respects, the Collateral Directive infringes upon core principles of security interests. A security interest combined with a 'right of use' and an enforcement regime without formal requirements are not compatible with those principles. In the case of a right of use, the collateral taker has a general right of disposal, which usually results in the degradation of the collateral provider's claim in respect of securities into a mere contractual claim against the collateral taker. The Collateral Directive also departs from commonly applied enforcement mechanisms, which are intended to prevent abuse and optimise proceeds, and in doing so balance the interests of collateral providers, their creditors and collateral takers. These developments in the field of property law undermine the fiduciary relationship between the collateral provider and collateral taker.¹¹

In the field of insolvency law, the Settlement Finality Directive and the Collateral Directive do not recognise the retroactive effect of the declaration of insolvency, and allow a level of protection in respect of legal acts concluded even after the declaration of insolvency. They also render inactive possibly applicable freeze periods. These latter developments are favourable to the insolvent party's counterparty in a system or under a financial collateral arrangement, and are detrimental to all other creditors of the insolvent estate.

Particularly in the case of transactions between major credit providers (notably banks) and small and medium-sized enterprises that receive credit in exchange for collateral, the new rules in the fields of property and insolvency law result in a major shift in the balance of power between the parties which benefits collateral takers.¹² Collateral takers, to whom collateral has been transferred or pledged under a financial collateral

11 It is therefore also regrettable that a comparable approach now seems to be taken by the drafters of the UNIDROIT Convention on Substantive Rules regarding Intermediated Securities.

12 Johansson 2005 also concludes that the directives lead to a shift in the balance of interests between collateral providers and takers.

agreement, are in a much stronger position than they were before the introduction of the new statutory regime. The costs of the new regime are borne, to a large extent, by the providers of collateral.

The following sections investigate how the goals of limiting systemic risk and improving liquidity can be reconciled with the interests of the different participants in the financial markets and how those interests, in turn, may be better balanced. One option is to restrictively interpret the Collateral Directive in its current form, which is discussed in section 3. A second possibility is to amend the texts of the Settlement Finality Directive and the Collateral Directive. This is the topic of section 4.

3. RESTRICTIVE OR EXTENSIVE SCOPE OF APPLICATION?

3.1 Introduction

Having investigated the consequences of the Collateral Directive (and the Dutch implementing law) in the fields of property law and insolvency law, it is now possible to determine whether these legislative instruments should be given a limited or a broad scope of application. In choosing between a restrictive or extensive interpretation, the interests of all the parties involved should be taken into account. It will come as no surprise that some providers of credit, such as banks, are satisfied with the Collateral Directive as it stands. The analysis in section 2 above shows that the directive generally benefits collateral takers. Collateral takers will, therefore, be in favour of a broad interpretation of the Collateral Directive. Because of the far-reaching consequences of this interpretation, in particular for collateral providers, one may, however, wonder whether the scope of application of the Collateral Directive should not be more limited. This issue is particularly significant when collateral providers are small or medium-sized enterprises, because in nearly all cases there is an unequal balance of power between those enterprises and major financial institutions that provide credit.

In respect of related changes in the Settlement Finality Directive, Vereecken supports a more restrictive interpretation:

The Directive departs from a number of fundamental principles in some jurisdictions, such as the equal treatment of unsecured creditors. This departure is

justified by the overriding need to contain systemic risk. However, it means that the scope of the Directive must be defined and interpreted in a restrictive way¹³

Arguably, the same holds true for the Collateral Directive. There are two ways to limit the scope of the Collateral Directive (and national implementing laws). First, the scope of the Collateral Directive can be limited to major market participants, thus ruling out minor market participants such as small and medium-sized enterprises. This possibility is discussed in section 3.2 below. A second way to limit the scope of the Collateral Directive, which will be treated in section 3.3 below, is to apply it only to financial instruments that meet a dual function requirement. In a restrictive interpretation, only financial collateral arrangements that serve both a recovery and a tradeability function are covered. In an extensive interpretation, financial collateral arrangements that serve a recovery function only also fall within the scope of the Collateral Directive.

3.2 Market participants

The first way to limit the scope of the Collateral Directive is to apply it only to major participants in the financial markets. These major market participants are listed in Article 1(2)(a)-(d) of the Collateral Directive. The clauses mention, for example, commercial and central banks, insurance and investment companies, and other major participants in the financial markets. These are indeed the entities most crucial to the continued liquidity of the cash and securities markets. The enterprises mentioned in Article 1(2)(e) of the Collateral Directive, which include small and medium-sized enterprises, have a far more limited impact on the liquidity of these markets. Consequently, there is no need to include them in the scope of the directive. In addition, applying the Collateral Directive to situations in which the collateral taker is by definition more powerful than the collateral provider is undesirable, as in such situations, the collateral taker can dictate the terms of the collateral agreement (e.g. whether a right of use is granted, and how enforcement takes place in the event of default). For these reasons the Collateral Directive should not apply to small and medium-sized enterprises. These enterprises can be excluded from the directive's scope of applicability on the basis of Article 1(3) of the Collateral Directive. It should be noted that in the original proposal for a Collateral Directive, small and medium-sized enterprises did not feature at all – and rightly so.¹⁴

¹³ See Vereecken / Nijenhuis 2003, p. 15

¹⁴ See Article 2(4) of the March 2001 Proposal

In practice, only a limited number of Member States has taken advantage of the opt-out offered by Article 1(3) of the Collateral Directive.¹⁵ On the basis of this provision, enterprises (including those that are small and medium-sized) can be excluded from the legislation implementing the Collateral Directive. One of the main arguments put forward against the exclusion of transactions involving enterprises in a single national market is that this exclusion may lead to such transactions taking place in another Member State that has opted for implementing legislation broader in scope. In the course of implementation in Germany, banks presented this argument in favour of a broad interpretation of the Collateral Directive.¹⁶ The Dutch government has also suggested the possibility of concluding transactions under the laws of a country other than the Netherlands as an argument to opt for an extensive scope of application that would include small and medium-sized enterprises.¹⁷

Originally, the German government proposed a limited interpretation of the law implementing the Collateral Directive, which excluded enter-

15 It appears that Austria, the Czech Republic, France, Germany, the Slovak Republic, Slovenia and Sweden (as well as Malta until March 2005) have done so in one way or another. All other European countries have also included transactions between the entities mentioned in Article 1(2)(a)-(d) of the CD and those mentioned in Article 1(2)(e). Belgium, Denmark, Hungary, Latvia and the United Kingdom envisage an even wider scope, also covering transactions between the entities mentioned in Article 1(2)(e) of the CD and/or transactions involving natural persons. For more background information, see in particular Lober / Klíma 2006 and the letter by the ISDA to the European Commission of 3 April 2006 concerning the evaluation of the Collateral Directive. See also Johansson 2005, section 3.3, Clifford Chance 2005, Lober 2005, the report of the debate on the implementation of the Collateral Directive in the First Chamber of the Dutch Parliament on 1 March 2005, in *Eerste Kamer*, 2005/17, in particular p. 770, the Dutch government's Explanatory Comments (*Memorie van Toelichting*) to the Second Chamber of the Dutch Parliament, in *Tweede Kamer*, 2004-2005, 30 138, no. 3, p. 5. See also (although somewhat biased, as only those countries that have chosen a broad interpretation are listed) the Dutch government's Additional Explanatory Memorandum (*Nadere Memorie van Antwoord*), in *Eerste Kamer*, 2004-2005, 28 874, E, section 22. For a general overview of the state of the implementation of the Collateral Directive in the different Member States, see the International Swaps and Derivatives Association website (www.isda.org, Committees / Collateral / Collateral Law Reform Group).

16 See, for example, the 12 February 2004 press release from the German Ministry of Justice concerning the '*Neuregelung für Finanzsicherheiten*'.

17 See the Dutch government's Additional Explanatory Memorandum (*Nadere Memorie van Antwoord*) to the First Chamber of Parliament, in *Eerste Kamer*, 2004-2005, 28 874, E, section 1.

prises.¹⁸ Later, however, in light of the argument that this approach may encourage market participants to conclude transactions in other national markets, the government proposed a broader interpretation, which included small and medium-sized enterprises. The German legislator was aware of the consequences of the Collateral Directive for property and insolvency law. The position of small and medium-sized enterprises, in particular, has been the subject of prolonged debate in the German *Bundestag* and *Bundesrat*. While this has not led to the exclusion of these enterprises from the scope of the German implementing law, it has led to another kind of restriction. Only certain types of financial transactions entered into by small and medium-sized enterprises, as indicated in § 5 of the *Kreditwesengesetz*, fall within the scope of the implementing law.¹⁹

Like the German legislator, the Dutch legislator has not made use of the possibility offered by Article 1(3) of the Collateral Directive of excluding enterprises from the scope of its implementing law. Quite the contrary, as originally, the Dutch legislator intended to go even further by giving the implementing law a much more extensive scope than that envisaged in the Collateral Directive. The first draft of the implementing law not only related to transactions between financial institutions and enterprises, but also to transactions between enterprises themselves. Because the First Chamber of Parliament did not agree with the Dutch government's approach, the government was forced – and rightly so – to make a new draft implementing law more limited in scope. This second draft law no longer applies to transactions between enterprises, but still covers transactions between financial institutions and enterprises.

Rather than exclude all enterprises on the basis of Article 1(3) of the Collateral Directive, another, more moderate solution would be to exclude only the most vulnerable small and medium-sized enterprises. In this scenario, only large enterprises, which are in a position of power equal to that of financial institutions, would fall within the scope of the Collateral Directive. A practical argument against this solution is that it may be difficult to formulate unequivocal criteria on a European level for enterprises to fulfil in order to fall within the scope of the Collateral Directive.

18 See the *Diskussionsentwurf des Bundesministeriums der Justiz, Entwurf eines Gesetzes zur Änderung der Insolvenzverordnung, des Bürgerlichen Gesetzbuches und anderer Gesetze*, pp. 19 and 38.

19 See also the explanatory comment to § 5 of the *Kreditwesengesetz* in the *Beschlussempfehlung und Bericht des Rechtausschusses, Deutscher Bundestag, Drucksache 15/2485*, 11 February 2004, p. 29.

Nonetheless, the thresholds related to capital base and gross assets set out in Article 2(4)(c) of the March 2001 Proposal for a Collateral Directive²⁰ and European directives in the field of corporate law could serve as a starting point in this respect. For Dutch law, Wagemakers has suggested that the Collateral Directive apply only to major joint stock companies as described in the NCC.²¹

3.3 Financial products

3.3.1 Introduction

A second way to limit the scope of the Collateral Directive is by applying it only to financial transactions that meet a dual function requirement. In line with this approach, financial collateral should serve both a recovery and a tradeability function. In the case of an outright transfer of title, both functions mentioned are present. If the parties opt for the provision of collateral on the basis of a security interest, the two functions are present only if the security interest is combined with a general right of disposal. In line with this approach, traditional security interests such as a right of pledge or a fiduciary transfer of title (which serve a recovery function only), fall outside the scope of the Collateral Directive.²²

3.3.2 Transfer of title

The Collateral Directive in any case applies to outright transfers of financial collateral. Such outright transfers occur under repurchase, securities lending or derivatives transactions. Financial collateral in this case serves both a recovery and a tradeability function.

In the case of a fiduciary transfer of title, however, the parties essentially intend to create a security interest. An extensive interpretation of the term

20 On a number of interpretation issues in respect of these thresholds, see the 2001 ISDA Statement of Position, section 1.

21 See the debate in the First Chamber of Parliament on 1 March 2005, EK 17, p. 769. Cf. the approach taken by the Slovenian legislator, outlined in the letter of 3 April 2006 by the ISDA to the European Commission concerning the evaluation of the Collateral Directive.

22 Hughes correctly notes that, essentially, the Collateral Directive is aimed at facilitating the operations of the wholesale markets in repos, stock lending and derivatives, but is not intended to apply to secured transactions involving cash and/or securities generally. See Hughes 2006, in particular the introduction and the section on the wholesale markets.

'financial collateral arrangement', which includes fiduciary transfers of title, has a negative impact on the position of collateral providers, especially if they are small and medium-sized enterprises. Both the Collateral Directive and the Dutch implementing law sideline a number of characteristic features of security interests that balance the interests of the parties involved. For example, Article 7:55 of the NCC explicitly states that provisions of pledge law may not be applied by way of analogy to title transfers. If this approach were to apply not only to outright transfers but also to fiduciary transfers of title, this would (as was also indicated in section 2.2 above) have the following consequences: (1) the fiduciary could appropriate the transferred assets, because the prohibition of appropriation of, for example, Article 3:235 of the NCC does not apply; (2) if the fiduciary were to opt for a sale, he could sell without being bound by any provisions relating to the way this sale should be executed (such as the mandatory provisions of pledge law relating to the public character of the sale, court approval or the intervention of an objective intermediary); (3) if the national legislator has not explicitly stated that the collateral taker should pay any remaining surplus value to the collateral provider after enforcement, as the Dutch legislator has done, the collateral taker could, arguably, stipulate that he is entitled to this surplus value. The result of an extensive interpretation of the definition of financial collateral arrangements, which includes fiduciary transfers of title, would therefore be that all mechanisms protecting collateral providers would be disabled to the benefit of the fiduciary.

Furthermore, the parties to a fiduciary transfer customarily do not intend to give the fiduciary an unlimited right to dispose of the objects given in security. He has a right of disposal only for purposes of recourse upon default by the collateral provider. For this reason, a fiduciary transfer of title lacks one of the characteristics of a financial collateral arrangement, i.e. tradeability. The impact of fiduciary transfers on the goal of the Collateral Directive to promote the liquidity of the cash and security markets is, therefore, limited.

In short, a fiduciary transfer of title contributes little to the goal of the Collateral Directive in respect of promoting the liquidity of the cash and securities markets, whereas an extensive interpretation of the definition of financial collateral arrangements would have a negative impact on the position of collateral providers, such as small and medium-sized enterprises. It can, therefore, be argued that fiduciary transfers of title should

not be financial collateral arrangements in the sense of the Collateral Directive and national implementing laws.

3.3.3 *Right of pledge*

With regard to a (fiduciary) transfer of title, both the text of the Collateral Directive and of the Dutch implementing law do, arguably, leave room for either an extensive or restrictive interpretation of the term 'financial collateral arrangement'. In the case of a security interest combined with a right of use, this is different. Article 5 of the Collateral Directive and Article 7:53 of the NCC state that a right of use *can* be granted. One could, for this reason, argue that a security interest without a right of use also falls within the scope of the Collateral Directive and the Dutch implementing law.²³

However, in the case of a traditional right of pledge, as with a fiduciary ownership right, the security taker does not have an unlimited right of disposal in respect of the collateral. As the collateral does not fulfil a tradeability function in this case, the Collateral Directive's goal of enhanced liquidity cannot be achieved. It must be kept in mind that the rights of collateral providers were suppressed in light of the argument concerning liquidity. The Collateral Directive's enforcement regime and the amendments to insolvency law it requires, make the protective mechanisms for collateral providers illusory. If liquidity is not enhanced, these changes cannot be justified. For these reasons, it is submitted that the term 'financial collateral arrangement' relates only to financial arrangements that actually enhance liquidity. Neither the text of the Collateral Directive nor the Dutch implementing law should be normative in this respect, but rather the directive's philosophy of liquidity should be. Whereas a security interest combined with a right of use does influence liquidity, a security interest without such a right of use has little or no impact on liquidity, and should not fall within the scope of the Collateral Directive and the Dutch implementing law.

3.3.4 *The dual function requirement*

The following are the main arguments in support of the dual function requirement. First, the structure of the internationally used market docu-

23 See, in this sense, for example, the Additional Explanatory Memorandum (*Nadere Memorie van Antwoord*), *Eerste Kamer*, 2004-2005, 28 874, E, section 1.

mentation for repos, securities lending agreements and derivatives (the GMRA, the GMSLA and the ISDA documentation), as well as that of agreements that are usually applied within a certain territory (the EMA, and the documentation of TBMA) show that both functions of financial collateral are always present. Second, market practice in, for example, the Netherlands, Germany, and the United Kingdom is based on the outright transfer method, because this is the only way, in accordance with general principles of civil law, to ensure that both functions are present. In the United States, both functions are, as a rule, also ensured but in this jurisdiction this is done either on the basis of the outright transfer method or by establishing a security interest combined with a general right of disposal. The third argument in support of the dual function requirement is the economic function of financial collateral and the goal of the Collateral Directive, i.e. the enhancement of the liquidity of cash and securities markets.

Traditional secured transactions, in which only the recovery function is envisaged, have little or no impact on liquidity. In this case, the non-tradable collateral assets are non-liquid from the outset. To a limited extent, an extensive interpretation of the Collateral Directive, which includes traditional secured loans, may enhance liquidity. If the Collateral Directive and its liberal enforcement regime were to apply to such transactions, this could lead to a reduction of costs for providers of credit and, as a result, allow them to lower their prices. This would make capital more readily available and have a positive impact on liquidity. It should, however, be noted that the potential impact on liquidity in this case is much smaller than in the scenario in which the collateral taker has an unlimited right of disposal. In the latter, both the collateral provider and the collateral taker are able to dispose of financial assets in the normal course of business. Providers of collateral would also pay a high price for this extensive interpretation of the Collateral Directive, as the mechanisms that protect their interests, such as prescribed sales and the prohibition of appropriation are rendered inapplicable. A limited impact on liquidity alone cannot justify a severe infringement on the rights of collateral providers.

The goal of the Collateral Directive is to enhance the liquidity of the cash and securities markets. For this reason, the Collateral Directive should apply to those transactions in the capital markets that do indeed enhance that liquidity. A defining characteristic of financial collateral arrangements (such as repurchase, securities lending and certain derivatives

transactions), is that both the collateral provider and the collateral taker are fully entitled to dispose of the cash and securities received. They are only under a contractual obligation to transfer equivalent assets at the end of a transaction. It is precisely these types of transactions that have a positive impact on the liquidity of the cash and securities markets. In the case of traditional secured transactions involving a right of pledge or a fiduciary transfer of title, the influence on liquidity is far more limited. Taking the goal of the Collateral Directive into account along with the negative consequences of the directive for small and medium-sized enterprises in particular, the directive should, in my view, be given a restrictive interpretation and only apply to transactions that meet the dual function requirement.

The German *Bundesrat* seems to be in favour of a comparable approach. The *Bundesrat* attached the following statement to its decision to approve the German law implementing the Collateral Directive:

[] In the course of the discussion in question in the German *Bundestag* the deficiencies of the Collateral Directive have become very clear. Besides the unfounded extension of the banking privilege to general economic transactions, another important aspect of these deficiencies is the lack of clarity concerning the kinds of security that can be established with such privileged financial collateral. For the scope of the directive this question is of central importance, even though the directive does not contain useful and reliable statements in this respect. Therefore it should be made particularly clear that privileging financial collateral is only possible in the case of typical capital markets transactions, and not in the general credit business of banks. This material limitation already follows from the goal of the directive []²⁴

In the same statement, the *Bundesrat* summoned the German government to promote a restrictive interpretation of the Collateral Directive on a European level.

24 See the attachment to the *Beschluss des Bundesrates* of 12 March 2004 concerning the Collateral Directive, no 117/04. Translation TK. Original German text '[] Bei den einschlägigen Beratungen im Deutschen Bundestag sind die gravierenden Mängel der Finanzsicherheitenrichtlinie deutlich zu Tage getreten. Zu diesen zählt neben der sachwidrigen Ausdehnung des Bankenprivilegs auf den allgemeinen gewerblichen Rechtsverkehr vor allem die Unklarheit darüber, welche Besicherungszwecke mit derart privilegierten Finanzsicherheiten verfolgt werden dürfen. Diese Frage ist für die Reichweite der Richtlinie von zentraler Bedeutung, ohne dass die Richtlinie hierzu brauchbare und verlässliche Aussagen enthielte. Daher wäre insbesondere klarzustellen, dass eine Bevorzugung von Finanzsicherheiten nur im Rahmen typischer Finanzmarktgeschäfte – und nicht im allgemeinen Kreditgeschäft der Banken – in Betracht kommt. Diese sachliche Grenzziehung folgt bereits aus dem Regelungszweck der Richtlinie []'

3.4 Conclusion

The Collateral Directive entails a disruption of the balance between collateral providers and collateral takers in a number of respects. A security interest combined with a right of use weakens the (proprietary) interest of the original owner and will usually leave him with a mere contractual claim against the collateral taker. The liberal enforcement regime of the Collateral Directive also entails changes to pledge law that are detrimental to collateral providers and beneficial to collateral takers. In addition, the changes that the Collateral Directive requires in insolvency law (retro-active effect is no longer given to the declaration of insolvency, legal acts are under certain circumstances enforceable even after the declaration of insolvency, and the freeze period no longer applies to financial collateral arrangements) are favourable to a creditor under a financial collateral arrangement and detrimental to the insolvent party and all his other creditors. These changes disturb carefully constructed balances in security and insolvency law, and therefore point to the conclusion that the Collateral Directive and the Dutch implementing law should be interpreted restrictively. In my view, this should be done by limiting the scope of these legislative instruments to major market participants, while not applying them to transactions involving small and medium-sized enterprises that have a subordinate effect on the liquidity of the financial markets. A second way to mitigate the negative consequences of the Collateral Directive for weaker economic players, is to limit the scope of the directive to financial products that guarantee both recovery and tradeability, and which, as such, support the Collateral Directive's main goal of enhancing liquidity.

4. RECOMMENDED CHANGES TO THE COLLATERAL DIRECTIVE AND THE SETTLEMENT FINALITY DIRECTIVE

4.1 Introduction

In order to limit systemic risk and to achieve the macro-economic goal of liquid markets for cash and securities, the European legislator has attempted to harmonise a number of provisions of property and insolvency law. The most important consequences of the Collateral Directive and the Settlement Finality Directive for property and insolvency law have been outlined in section 2 above. Generally these changes are favourable to credit providers / collateral takers and are unfavourable to

collateral providers. The European legislator's approach has particularly negative consequences for parties in a weaker position such as small and medium-sized enterprises. One wonders whether the macro-economic goals relating to systemic risk and liquidity could not have been attained by adopting another means of harmonising provisions of property and insolvency law. This section investigates how the negative consequences of the changes to property and insolvency law can be mitigated, and how the balance between the different participants can be restored. To this end, concrete proposals are made for amendments to the Collateral Directive and the Settlement Finality Directive. On the one hand, the proposed amendments honour the goals of a limitation of systemic risk and an enhancement of liquidity, which are deserving of full support, whereas on the other, they restore the balance between collateral providers and collateral takers.

4.2 Limitation to major market participants

One of the main deficiencies of the Collateral Directive is that it applies not only to major financial market participants, but also to arrangements between major participants and minor participants, such as small and medium-sized enterprises. This means that a stronger collateral taker can stipulate contractual terms that are advantageous to himself, for instance where the manner of enforcement or the establishment of a right of use is concerned, but which are detrimental to the weaker collateral provider who is in need of credit.

For this reason, it is proposed that the Collateral Directive should be amended so as to apply to major participants in the financial markets only. This means that Article 1(2)(e) and Article 1(3) of the Collateral Directive should be repealed. Article 1(2)(d) of the directive should also be reconsidered, because a 'person [...] who acts in a trust or representative capacity on behalf of any one or more persons that includes any bondholders or holders of other forms of securitised debt' can also, in practice, be a minor participant. A comparable approach is in line with the European Commission's original proposal for a directive on financial collateral, which applied to major participants only.

Another issue to be considered is that there are entities, such as pension funds, that are important for the liquidity of the cash and securities markets, but that are not listed in the Collateral Directive as entities to which the directive applies.

4.3 The abolition of or an amendment to the right of use

The European legislator's introduction of a security interest combined with a right of use is unfortunate. This construction is not compatible with traditional principles of pledge law and is detrimental to collateral providers. It blurs the traditional distinction between a security interest and an outright transfer, and establishes an undesirable precedent. To support the liquidity of the markets, the European legislator should have confined himself to sanctioning the European market standard of the provision of financial collateral by way of an outright transfer. It would be best if the right of use were removed from the Collateral Directive.

Alternatively, the following two amendments could be made to the Collateral Directive in order to make the consequences of the right of use more acceptable. The first is to amend the terminology used. Instead of speaking of a 'right of use' it would be better to use the term 'general right of disposal' in the Collateral Directive. This terminology would make the effects of the construction clearer.

In addition, the rule of proprietary substitution set out in Article 5(3) of the Collateral Directive needs to be revised. This rule should not be limited to equivalent assets transferred by the collateral taker at the moment that he deems fit. Ideally, proprietary substitution takes place immediately in relation to all kinds of replacement assets (e.g. sale proceeds). If this is impractical in light of, for example, clearing and netting arrangements, substitution should relate to equivalent assets as soon as the collateral taker becomes entitled to them. Such an amendment would prevent, or at least limit, the time frame in which a collateral provider is left with a mere contractual claim against the collateral taker.

4.4 Close-out netting

The Collateral Directive sets out a liberal regime for the enforcement of security interests and close-out netting. This guarantees the continued liquidity of the cash and securities markets in the event of the default of one market participant and, as such, limits systemic risk. In particular, if major market participants are equally powerful, this approach can be justified. It should nonetheless be taken into account that easy enforcement by one creditor has a negative effect on the position of all other creditors. A cautious approach is therefore required when considering to what extent national limitations on enforcement should be set aside.

As far as close-out netting is concerned, improvements are possible. National law still plays a prevalent role in this respect. This is mainly because recital 15 of the Collateral Directive refers to national law in relation to a number of crucial issues, such as the reciprocity requirement and the issue of voidable preference. In addition, there are topics in the field of close-out netting that the Collateral Directive simply does not address, such as the moment at which the claims involved should be valued. In order to come to a uniform close-out netting regime in Europe, the issue should be readdressed.

4.5 No enforceability of legal acts after the declaration of insolvency

One final issue worthy of reconsideration deals with the provisions in the Settlement Finality Directive and the Collateral Directive, which open up the possibility of enforcing legal acts entered into after the declaration of insolvency. The European legislator has not made it sufficiently clear that there are grounds for setting aside the fixation and *pari passu* principles, and for putting individual counterparties of an insolvent entity in a system or under a financial collateral agreement in an advantageous position. The rule of the directives can lead to undesirable situations in which an insolvent entity benefits individual creditors to the detriment of the other creditors.

4.6 No changes required: retroactive effect of the declaration of insolvency, freeze period

There is no need to change the insolvency rules set out in the Settlement Finality Directive and the Collateral Directive relating to the zero hour rule and the freeze period. The abolition of the zero hour rule does justice to the principle that insolvency should take effect as of the moment it is declared by a judge. The non-applicability of the freeze period can be justified in the case of transactions between major financial market participants, because the application of a freeze period would hamper the liquidity of the financial markets and increase systemic risk.

SUMMARY

This study relates to financial collateral arrangements, under which parties provide each other with cash and/or securities. These arrangements are primarily studied from a legal point of view.

After a general introduction in chapter I, chapter II examines how the financial collateral markets currently operate. It defines financial collateral, examines a number of examples of transactions involving financial collateral, such as repurchase, securities lending and derivatives transactions, and describes which standardised agreements are commonly used to document such transactions. Chapter II also pays attention to the main players in the financial collateral markets, i.e. commercial market participants such as banks, insurance undertakings and investment firms. Central banks also enter into collateralised transactions on a large scale. The chapter concludes by outlining the legal framework for financial collateral arrangements. On a European level, such arrangements are primarily regulated by the Collateral Directive, and also to a certain extent, by the Settlement Finality Directive. In order to guarantee liquid cash and securities markets in the European Union, these directives set out uniform legal regimes for systems in which transfers of cash and securities are settled, and for financial collateral arrangements. In particular, they require the harmonisation on a national level of a number of issues of property and insolvency law.

Chapter III pays attention to the first method to provide collateral, i.e. the outright transfer method. This method is set out in internationally applied standard agreements for transactions involving financial collateral and is the market standard throughout Europe. Under Dutch law, this method prompts the question of whether a transfer is 'outright' or should be characterised as 'fiduciary', which is important in light of the prohibition of fiduciary transfers under the NCC. Chapter III proposes that a function-based approach should be taken in relation to the issue of the so-called 'recharacterisation' of an outright transfer as a security interest. This means that no recharacterisation risk is present if the parties intend collateral to fulfil the two functions of recovery and tradeability. If, however, the parties only envisage a recovery function, it is submitted that they should establish a security interest. The Collateral Directive requires that

any risk of recharacterisation is eliminated and that a title transfer arrangement can take effect in accordance with its terms.

Chapter IV examines a second method to provide collateral, i.e. vesting a security interest combined with a general right of disposal for the secured party. This method first flourished in the United States. Its origins are in the broker-dealer market's right of repledge. Under certain circumstances, a right of repledge can, under American law, impair the rights of the original owner. A collateral taker's general right of disposal, which has been applied in the American derivatives and securities lending markets for the last twenty years or so, can be seen as a radical interpretation of the impairing repledge. Pressure by London market participants has been a factor that has led to the appearance of this construction in Europe, where the Collateral Directive has introduced a security interest combined with a 'right of use', i.e. a collateral taker's general right of disposal in respect of encumbered assets. The construction is hardly compatible, though, with basic notions of American, English, Dutch and German property law and can, in terms of content, be equated to an outright transfer. In practice, this construction usually reduces the collateral provider's (proprietary) claim in respect of assets to a mere contractual claim against the collateral taker.

Chapter V examines the approach of the Collateral Directive in respect of enforcement. The Collateral Directive envisages a liberal enforcement regime in respect of security interests, such as a right of pledge or a fiduciary ownership right. Commonly applied, mandatory formal requirements of pledge law guaranteeing optimum proceeds, such as a public sale of encumbered assets or the intervention of an objective intermediary, are rendered inapplicable. Moreover, the directive as a standard envisages the non-applicability of the prohibition of appropriation. Because the Collateral Directive requires that title transfer arrangements are enforceable in accordance with their terms, these characteristics of pledge law, arguably, also cannot be applied by way of analogy to fiduciary ownership rights. The Collateral Directive's approach in relation to the enforcement of security interests means that a stronger provider of credit can determine the content of the fiduciary relationship between the parties and, in particular, on what terms enforcement takes place.

Moreover, close-out netting provisions, which commonly form part of title transfer arrangements, are generally enforceable under the Collateral Directive. It should be noted, however, that a number of crucial issues

relating to reciprocity, similarity, voidable preference and the moment at which the claims involved are valued, should still be determined under national law.

In the field of insolvency law, the Settlement Finality Directive and the Collateral Directive abolish the retroactive effect of the declaration of insolvency, make it possible to enforce legal acts that have been carried out after the declaration of insolvency, and prohibit the application of a freeze period.

Chapter VI concludes that the changes required by the Settlement Finality Directive and the Collateral Directive in the field of property and insolvency law contribute to liquid markets. At the same time, it should be noted that they are, in all cases, favourable to credit providers/collateral takers and detrimental to collateral providers and their other creditors. Particularly in the case of collateral providers who do not enjoy an equal position of power when compared with major financial institutions, such as small and medium-sized enterprises, this may lead to undesirable results. Chapter VI investigates what can be done in order to safeguard liquidity on the one hand, while taking into account the interests of weaker economic players on the other.

Under current law there are two ways to limit the scope of the Collateral Directive. First, the text of the directive allows application of its provisions to transactions between major market participants only. These participants in particular are important for overall liquidity. Small and medium-sized enterprises may and should be excluded. A second way to limit the scope of the Collateral Directive is to interpret the term 'financial collateral arrangements' as relating to transactions that serve the two functions of recovery and tradeability only. This interpretation limits the scope of the directive to transactions that truly enhance liquidity. It does not extend to traditional security interests that serve a recovery function only.

In addition, a number of changes can be made to the Settlement Finality Directive and the Collateral Directive, which honour the goal of improved liquidity and which at the same time restore the balance between the different participants in the financial markets. First, the Collateral Directive should apply only to major participants in the financial markets. Second, the construction of a security interest combined with a general right of disposal should best be repealed, or, alternatively, the terminology used ('general right of disposal' rather than 'right of use') and the rule

of proprietary substitution connected with this construction should be revised. A third improvement would be to readdress the Collateral Directive's rules on close-out netting, which in their current form leave many issues to be decided under rules of national law. A fourth issue that deserves reconsideration is the rule of the Settlement Finality Directive and the Collateral Directive, which makes it possible to enforce legal acts that have been entered into after the declaration of insolvency, because this rule thwarts the fixation and *pari passu* principles and may be misused. There is no need to revise the rules of the Settlement Finality Directive and the Collateral Directive, which abolish the retroactive effect of the declaration of insolvency and render freeze periods inoperable.

Dit boek heeft betrekking op financiële zekerheidsovereenkomsten op grond waarvan partijen elkaar geld en/of effecten verschaffen. Deze overeenkomsten worden in het bijzonder beschouwd vanuit een juridisch gezichtspunt.

Na een algemene introductie in hoofdstuk I, komt in hoofdstuk II de wijze waarop de markt voor financiële zekerheidsovereenkomsten is ingericht aan de orde. Achtereenvolgens wordt uitgelegd wat onder financiële zekerheden wordt verstaan, worden voorbeelden gegeven van transacties met zulke zekerheden, zoals *repurchase*-, *securities lending*- en derivaten-transacties, en worden de raamovereenkomsten beschreven op basis waarvan zulke transacties in de regel worden aangegaan. Hoofdstuk II besteedt ook aandacht aan de belangrijkste marktdeelnemers die gebruik maken van financiële zekerheidsovereenkomsten. Op de commerciële markt zijn dit bijvoorbeeld banken, verzekeringsinstellingen en beleggingsinstellingen. Daarnaast maken centrale banken op grote schaal gebruik van financiële zekerheden. Het hoofdstuk wordt afgesloten met een overzicht van de wetgeving binnen het kader waarvan financiële zekerheidsovereenkomsten moeten worden afgesloten. Op Europees niveau moet men hierbij met name denken aan de Richtlijn betreffende financiële zekerheidsovereenkomsten, terwijl ook de Finaliteitsrichtlijn tot op zekere hoogte betrekking heeft op deze materie. Met het oog op liquide geld- en effectenmarkten voorzien deze richtlijnen in uniforme regels voor systemen waarin boekingen van geld en effecten worden afgewikkeld en voor financiële zekerheidsovereenkomsten. Op grond van deze richtlijnen zijn Lidstaten verplicht een aantal nationale bepalingen van goederen- en faillissementsrecht te harmoniseren.

Hoofdstuk III besteedt aandacht aan een eerste methode om financiële zekerheden te verschaffen, namelijk door overdracht. Een aantal internationaal gebruikte raamovereenkomsten op grond waarvan transacties met financiële zekerheden worden aangegaan, voorziet in deze methode. In Europa is de methode van overdracht de marktstandaard. Naar Nederlands recht roept deze methode de vraag op of het hier gaat om een 'volledige' of om een fiduciaire overdracht. Deze vraag is van belang in het licht van het fiducia-verbod dat is neergelegd in het Burgerlijk Wetboek. In hoofdstuk III wordt het standpunt verdedigd dat men een functionele

invalshoek moet kiezen bij het beantwoorden van de vraag of een overdracht niet in wezen als een zekerheidsstelling moet worden gekwalificeerd. Bezien vanuit deze invalshoek is een overdracht 'volledig', als partijen de twee functies van verhaal en verhandelbaarheid voor ogen hebben. Indien zij echter slechts de functie van verhaal beogen, hadden zij een zekerheidsrecht moeten vestigen. De Richtlijn betreffende financiële-zekerheidsovereenkomsten schrijft voor dat een financiëlezekerheidsovereenkomst tot overdracht niet als een zekerheidsstelling mag worden gekwalificeerd en dat zo een overeenkomst afdwingbaar moet zijn met inachtneming van de daarin vervatte bepalingen.

Hoofdstuk IV onderzoekt de tweede methode om financiële zekerheden te verschaffen, namelijk door het vestigen van een zekerheidsrecht met een daaraan gekoppelde algemene beschikkingsbevoegdheid voor de zekerheidsnemer. Deze methode is opgekomen in de Verenigde Staten. Haar oorsprong is gelegen in de herverpanding zoals die werd toegepast in de *broker-dealer* markt. Onder omstandigheden kan zo een recht van herverpanding afbreuk doen aan de aanspraken van de oorspronkelijke eigenaar. De figuur van een zekerheidsnemer met algemene beschikkingsbevoegdheid, welke sinds een jaar of twintig in de Amerikaanse *securities lending*- en derivaten-markten wordt toegepast, kan worden gezien als een radicale toepassing van de herverpanding die afbreuk doet aan de rechten van de oorspronkelijke eigenaar. Druk die werd uitgeoefend door Londense marktdeelnemers, is een factor geweest die heeft bijgedragen aan de introductie van de figuur van het 'gebruiksrecht' in de Europese Richtlijn betreffende financiëlezekerheidsovereenkomsten. Onder het recht van 'gebruik' wordt in dit verband algemene beschikkingsbevoegdheid verstaan. De figuur van een zekerheidsnemer met algemene beschikkingsbevoegdheid is echter niet te rijmen met grondbeginselen van Amerikaans, Engels, Nederlands en Duits goederenrecht. Zij kan naar haar inhoud worden gelijkgesteld met een volledige overdracht. Praktisch gezien heeft deze figuur in de regel ten gevolge dat de (goederenrechtelijke) aanspraak van de zekerheidsgever ten aanzien van een goed wordt gereduceerd tot een verbintenisrechtelijke aanspraak jegens de zekerheidsnemer.

Hoofdstuk V gaat in op de wijze waarop uitwinning plaatsvindt conform de Richtlijn betreffende financiëlezekerheidsovereenkomsten. De richtlijn voorziet in een liberaal regime waar het gaat om de uitwinning van zekerheden, zoals een pandrecht of een fiduciar eigendomsrecht. Traditioneel toegepaste, dwingendrechtelijke voorschriften betreffende de uitwinning

van een pandrecht, zoals de openbare verkoop of de tussenkomst van een onafhankelijke tussenpersoon, zijn buiten toepassing verklaard. Daarnaast schaft de richtlijn in beginsel het toe-eigeningsverbod af. Omdat de richtlijn voorschrijft dat financiële zekerheidsovereenkomsten tot overdracht afdwingbaar moeten zijn met inachtneming van de daarin vervatte bepalingen, is het verdedigbaar dat de analogische toepassing van de dwingende pandbepalingen op de fiduciaire overdracht eveneens is uitgesloten. De wijze waarop de richtlijn de uitwinning van zekerheidsrechten benadert, betekent dat een kredietverschaffer met een sterke machtspositie kan bepalen hoe de fiduciaire verhouding tussen partijen wordt vormgegeven, en in het bijzonder op welke wijze uitwinning plaatsvindt.

Daarnaast bepaalt de Richtlijn betreffende financiële zekerheidsovereenkomsten in algemene termen dat contractuele afspraken betreffende *close-out netting* afdwingbaar zijn. Er moet echter rekening mee worden gehouden dat het nationale recht nog steeds een rol speelt waar het gaat om belangrijke onderwerpen als wederkerigheid, gelijksoortigheid, de *actio pauliana* en het moment waarop de verbintenissen waar de verrekening betrekking op heeft, worden gewaardeerd.

Op het gebied van het faillissementsrecht hebben de Finaliteitsrichtlijn en de Richtlijn betreffende financiële zekerheidsovereenkomsten de volgende gevolgen. Zij schaffen de terugwerkende kracht van de insolventverklaring af, voorzien onder omstandigheden in de afdwingbaarheid van rechtshandelingen na het moment van de insolventverklaring en sluiten de toepasselijkheid van een afkoelingsperiode uit.

In hoofdstuk VI wordt tot de slotsom gekomen dat de wijzigingen waar-toe de Finaliteitsrichtlijn en de Richtlijn betreffende financiële zekerheidsovereenkomsten verplichten, bijdragen tot liquide geld- en effectenmarkten. Tegelijkertijd moet worden geconstateerd dat zij in alle gevallen in het voordeel zijn van kredietverschaffers/zekerheidsnemers en ten nadele van zekerheidsverschaffers en hun andere crediteuren. In het bijzonder in het geval van zekerheidsverschaffers die een minder sterke positie innemen dan grote financiële instellingen, zoals kleine en middelgrote ondernemingen, kan dit tot onwenselijke resultaten leiden. In hoofdstuk VI wordt onderzocht wat er gedaan kan worden om liquiditeit te waarborgen en tegelijkertijd recht te doen de belangen van zwakkere deelnemers aan het economisch leven.

Naar huidig recht zijn er twee manieren waarop de reikwijdte van de Richtlijn betreffende financiëlezekerheidsovereenkomsten kan worden ingeperkt. Ten eerste is het op grond van de richtlijn toegestaan haar bepalingen slechts toe te passen op transacties tussen grote marktpartijen. Het zijn juist deze partijen die van belang zijn voor liquide markten. Kleine en middelgrote ondernemingen kunnen en moeten buiten het toepassingsbereik worden gehouden. Een tweede manier om het toepassingsbereik van de richtlijn in te perken is door het begrip 'financiëlezekerheidsovereenkomst' eng uit te leggen en alleen toe te passen in die gevallen waarin financiële zekerheden de twee kenmerkende functies van verhaal en verhandelbaarheid vervullen. Een dergelijke interpretatie beperkt de reikwijdte van de richtlijn tot transacties die daadwerkelijk de liquiditeit bevorderen. Traditionele zekerheidsconstructies die enkel strekken tot verhaal vallen hiermee buiten de reikwijdte.

Daarnaast is het mogelijk een aantal wijzigingen aan te brengen in de Finaliteitsrichtlijn en de Richtlijn betreffende financiëlezekerheidsovereenkomsten, dat enerzijds recht doet aan het oogmerk de liquiditeit te stimuleren en anderzijds het evenwicht tussen de belangen van de verschillende betrokken marktdeelnemers herstelt. Ten eerste zou de Richtlijn betreffende financiëlezekerheidsovereenkomsten alleen betrekking moeten hebben op grote spelers op de financiële markten. Ten tweede zou het het beste zijn als de figuur van een zekerheidsrecht met een daaraan gekoppelde algemene beschikkingsbevoegdheid voor de zekerheidsnemer werd afgeschaft. Het alternatief is de in dit verband gehanteerde terminologie te wijzigen ('algemene beschikkingsbevoegdheid' in plaats van 'gebruiksrecht'), alsmede de met deze figuur verbonden substitutieregel. Een derde mogelijke verbetering betreft een heroverweging van de bepalingen van de Richtlijn betreffende financiëlezekerheidsovereenkomsten inzake *close-out netting*, omdat een aantal belangrijke vragen hieromtrent nog steeds naar nationaal recht moeten worden bepaald. Een vierde onderwerp dat aandacht behoeft is de regel van de Finaliteitsrichtlijn en de Richtlijn betreffende financiëlezekerheidsovereenkomsten op grond waarvan onder omstandigheden rechtshandelingen die zijn verricht na de insolventverklaring afdwingbaar zijn. Deze regel is een inbreuk op het fixatie- en het *pari passu*-beginsel en kan leiden tot misstanden. Er is geen reden om de regels van de Finaliteitsrichtlijn en de Richtlijn betreffende financiëlezekerheidsovereenkomsten aan te passen, welke de terugwerkende kracht van de insolventverklaring en de afkoelingsperiode buiten werking stellen.

APPENDIX I

TEXT OF THE SETTLEMENT FINALITY DIRECTIVE

**DIRECTIVE 98/26/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL
of 19 May 1998 on settlement finality in payment and securities settlement systems**

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 100a thereof,

Having regard to the proposal from the Commission¹,

Having regard to the opinion of the European Monetary Institute²,

Having regard to the opinion of the Economic and Social Committee³,

Acting in accordance with the procedure laid down in Article 189b of the Treaty⁴,

- (1) Whereas the Lamfalussy report of 1990 to the Governors of the central banks of the Group of Ten Countries demonstrated the important systemic risk inherent in payment systems which operate on the basis of several legal types of payment netting, in particular multilateral netting, whereas the reduction of legal risks associated with participation in real time gross settlement systems is of paramount importance, given the increasing development of these systems,
- (2) Whereas it is also of the utmost importance to reduce the risk associated with participation in securities settlement systems, in particular where there is a close connection between such systems and payment systems,
- (3) Whereas this Directive aims at contributing to the efficient and cost effective operation of cross-border payment and securities settlement arrangements in the Community, which reinforces the freedom of movement of capital in the internal market, whereas this Directive thereby follows up the progress made towards completion of the internal market, in particular towards the freedom to provide services and liberalisation of capital movements, with a view to the realisation of Economic and Monetary Union,
- (4) Whereas it is desirable that the laws of the Member States should aim to minimise the disruption to a system caused by insolvency proceedings against a participant in that system,
- (5) Whereas a proposal for a Directive on the reorganisation and winding-up of credit institutions submitted in 1985 and amended on 8 February 1988 is still pending before

1 OJ C 207, 18 7 1996, p 13, and OJ C 259, 26 8 1997, p 6

2 Opinion delivered on 21 November 1996

3 OJ C 56, 24 2 1997, p 1

4 Opinion of the European Parliament of 9 April 1997 (OJ C 132, 28 4. 1997, p 74), Council Common Position of 13 October 1997 (OJ C 375, 10 12 1997, p 34) and Decision of the European Parliament of 29 January 1998 (OJ C 56, 23 2 1998) Council Decision of 27 April 1998

the Council, whereas the Convention on Insolvency Proceedings drawn up on 23 November 1995 by the Member States meeting within the Council explicitly excludes insurance undertakings, credit institutions and investment firms,

- (6) Whereas this Directive is intended to cover payment and securities settlement systems of a domestic as well as of a cross-border nature, whereas the Directive is applicable to Community systems and to collateral security constituted by their participants, be they Community or third country participants, in connection with participation in these systems,
- (7) Whereas Member States may apply the provisions of this Directive to their domestic institutions which participate directly in third country systems and to collateral security provided in connection with participation in such systems,
- (8) Whereas Member States should be allowed to designate as a system covered by this Directive a system whose main activity is the settlement of securities even if the system to a limited extent also deals with commodity derivatives,
- (9) Whereas the reduction of systemic risk requires in particular the finality of settlement and the enforceability of collateral security, whereas collateral security is meant to comprise all means provided by a participant to the other participants in the payment and/or securities settlement systems to secure rights and obligations in connection with that system, including repurchase agreements, statutory liens and fiduciary transfers, whereas regulation in national law of the kind of collateral security which can be used should not be affected by the definition of collateral security in this Directive,
- (10) Whereas this Directive, by covering collateral security provided in connection with operations of the central banks of the Member States functioning as central banks, including monetary policy operations, assists the European Monetary Institute in its task of promoting the efficiency of cross-border payments with a view to the preparation of the third stage of Economic and Monetary Union and thereby contributes to developing the necessary legal framework in which the future European central bank may develop its policy,
- (11) Whereas transfer orders and their netting should be legally enforceable under all Member States jurisdictions and binding on third parties,
- (12) Whereas rules on finality of netting should not prevent systems testing, before the netting takes place, whether orders that have entered the system comply with the rules of that system and allow the settlement of that system to take place,
- (13) Whereas nothing in this Directive should prevent a participant or a third party from exercising any right or claim resulting from the underlying transaction which they may have in law to recovery or restitution in respect of a transfer order which has entered a system, e.g. in case of fraud or technical error, as long as this leads neither to the unwinding of netting nor to the revocation of the transfer order in the system,
- (14) Whereas it is necessary to ensure that transfer orders cannot be revoked after a moment defined by the rules of the system,

- (15) Whereas it is necessary that a Member State should immediately notify other Member States of the opening of insolvency proceedings against a participant in the system;
- (16) Whereas insolvency proceedings should not have a retroactive effect on the rights and obligations of participants in a system;
- (17) Whereas, in the event of insolvency proceedings against a participant in a system, this Directive furthermore aims at determining which insolvency law is applicable to the rights and obligations of that participant in connection with its participation in a system;
- (18) Whereas collateral security should be insulated from the effects of the insolvency law applicable to the insolvent participant;
- (19) Whereas the provisions of Article 9(2) should only apply to a register, account or centralized deposit system which evidences the existence of proprietary rights in or for the delivery or transfer of the securities concerned;
- (20) Whereas the provisions of Article 9(2) are intended to ensure that if the participant, the central bank of a Member State or the future European central bank has a valid and effective collateral security as determined under the law of the Member State where the relevant register, account or centralized deposit system is located, then the validity and enforceability of that collateral security as against that system (and the operator thereof) and against any other person claiming directly or indirectly through it, should be determined solely under the law of that Member State;
- (21) Whereas the provisions of Article 9(2) are not intended to prejudice the operation and effect of the law of the Member State under which the securities are constituted or of the law of the Member State where the securities may otherwise be located (including, without limitation, the law concerning the creation, ownership or transfer of such securities or of rights in such securities) and should not be interpreted to mean that any such collateral security will be directly enforceable or be capable of being recognised in any such Member State otherwise than in accordance with the law of that Member State;
- (22) Whereas it is desirable that Member States endeavour to establish sufficient links between all the securities settlement systems covered by this Directive with a view towards promoting maximum transparency and legal certainty of transactions relating to securities;
- (23) Whereas the adoption of this Directive constitutes the most appropriate way of realising the abovementioned objectives and does not go beyond what is necessary to achieve them,

HAVE ADOPTED THIS DIRECTIVE:

SECTION I

SCOPE AND DEFINITIONS

Article 1

The provisions of this Directive shall apply to

- (a) any system as defined in Article 2(a), governed by the law of a Member State and operating in any currency, the ecu or in various currencies which the system converts one against another,
- (b) any participant in such a system,
- (c) collateral security provided in connection with
 - participation in a system, or
 - operations of the central banks of the Member States in their functions as central banks

Article 2

For the purpose of this Directive

- (a) system shall mean a formal arrangement
 - between three or more participants, without counting a possible settlement agent, a possible central counterparty, a possible clearing house or a possible indirect participant, with common rules and standardised arrangements for the execution of transfer orders between the participants,
 - governed by the law of a Member State chosen by the participants, the participants may, however, only choose the law of a Member State in which at least one of them has its head office, and
 - designated, without prejudice to other more stringent conditions of general application laid down by national law, as a system and notified to the Commission by the Member State whose law is applicable, after that Member State is satisfied as to the adequacy of the rules of the system

Subject to the conditions in the first subparagraph, a Member State may designate as a system such a formal arrangement whose business consists of the execution of transfer orders as defined in the second indent of (1) and which to a limited extent executes orders relating to other financial instruments, when that Member State considers that such a designation is warranted on grounds of systemic risk

A Member State may also on a case-by-case basis designate as a system such a formal arrangement between two participants, without counting a possible settlement agent, a possible central counterparty, a possible clearing house or a possible indirect participant, when that Member State considers that such a designation is warranted on grounds of systemic risk,

- (b) institution shall mean

- a credit institution as defined in the first indent of Article 1 of Directive 77/780/EEC⁵ including the institutions set out in the list in Article 2(2) thereof, or
- an investment firm as defined in point 2 of Article 1 of Directive 93/22/EEC⁶ excluding the institutions set out in the list in Article 2(2)(a) to (k) thereof, or
- public authorities and publicly guaranteed undertakings, or
- any undertaking whose head office is outside the Community and whose functions correspond to those of the Community credit institutions or investment firms as defined in the first and second indent,

which participates in a system and which is responsible for discharging the financial obligations arising from transfer orders within that system.

If a system is supervised in accordance with national legislation and only executes transfer orders as defined in the second indent of (i), as well as payments resulting from such orders, a Member State may decide that undertakings which participate in such a system and which have responsibility for discharging the financial obligations arising from transfer orders within this system, can be considered institutions, provided that at least three participants of this system are covered by the categories referred to in the first subparagraph and that such a decision is warranted on grounds of systemic risk;

- (c) 'central counterparty' shall mean an entity which is interposed between the institutions in a system and which acts as the exclusive counterparty of these institutions with regard to their transfer orders;
- (d) 'settlement agent' shall mean an entity providing to institutions and/or a central counterparty participating in systems, settlement accounts through which transfer orders within such systems are settled and, as the case may be, extending credit to those institutions and/or central counterparties for settlement purposes;
- (e) 'clearing house' shall mean an entity responsible for the calculation of the net positions of institutions, a possible central counterparty and/or a possible settlement agent;
- (f) 'participant' shall mean an institution, a central counterparty, a settlement agent or a clearing house.

According to the rules of the system, the same participant may act as a central counterparty, a settlement agent or a clearing house or carry out part or all of these tasks.

A Member State may decide that for the purposes of this Directive an indirect participant may be considered a participant if it is warranted on the grounds of systemic risk and on condition that the indirect participant is known to the system;

5 First Council Directive 77/780/EEC of 12 December 1977 on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions (OJ L 322, 17. 12. 1977, p. 30). Directive as last amended by Directive 96/13/EC (OJ L 66, 16. 3. 1996, p. 15).

6 Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field (OJ L 141, 11. 6. 1993, p. 27). Directive as last amended by Directive 97/9/EC (OJ L 84, 26. 3. 1997, p. 22).

- (g) 'indirect participant' shall mean a credit institution as defined in the first indent of (b) with a contractual relationship with an institution participating in a system executing transfer orders as defined in the first indent of (i) which enables the abovementioned credit institution to pass transfer orders through the system,
- (h) 'securities' shall mean all instruments referred to in section B of the Annex to Directive 93/22/EEC,
- (i) 'transfer order' shall mean
 - any instruction by a participant to place at the disposal of a recipient an amount of money by means of a book entry on the accounts of a credit institution, a central bank or a settlement agent, or any instruction which results in the assumption or discharge of a payment obligation as defined by the rules of the system, or
 - an instruction by a participant to transfer the title to, or interest in, a security or securities by means of a book entry on a register, or otherwise,
- (j) 'insolvency proceedings' shall mean any collective measure provided for in the law of a Member State, or a third country, either to wind up the participant or to reorganise it, where such measure involves the suspending of, or imposing limitations on, transfers or payments,
- (k) 'netting' shall mean the conversion into one net claim or one net obligation of claims and obligations resulting from transfer orders which a participant or participants either issue to, or receive from, one or more other participants with the result that only a net claim can be demanded or a net obligation be owed,
- (l) 'settlement account' shall mean an account at a central bank, a settlement agent or a central counterparty used to hold funds and securities and to settle transactions between participants in a system,
- (m) 'collateral security' shall mean all realisable assets provided under a pledge (including money provided under a pledge), a repurchase or similar agreement, or otherwise, for the purpose of securing rights and obligations potentially arising in connection with a system, or provided to central banks of the Member States or to the future European central bank

SECTION II

NETTING AND TRANSFER ORDERS

Article 3

- 1 Transfer orders and netting shall be legally enforceable and, even in the event of insolvency proceedings against a participant, shall be binding on third parties, provided that transfer orders were entered into a system before the moment of opening of such insolvency proceedings as defined in Article 6(1)
Where, exceptionally, transfer orders are entered into a system after the moment of opening of insolvency proceedings and are carried out on the day of opening of such

proceedings, they shall be legally enforceable and binding on third parties only if, after the time of settlement, the settlement agent, the central counterparty or the clearing house can prove that they were not aware, nor should have been aware, of the opening of such proceedings

- 2 No law, regulation, rule or practice on the setting aside of contracts and transactions concluded before the moment of opening of insolvency proceedings, as defined in Article 6(1) shall lead to the unwinding of a netting
- 3 The moment of entry of a transfer order into a system shall be defined by the rules of that system. If there are conditions laid down in the national law governing the system as to the moment of entry, the rules of that system must be in accordance with such conditions

Article 4

Member States may provide that the opening of insolvency proceedings against a participant shall not prevent funds or securities available on the settlement account of that participant from being used to fulfil that participant's obligations in the system on the day of the opening of the insolvency proceedings. Furthermore, Member States may also provide that such a participant's credit facility connected to the system be used against available, existing collateral security to fulfil that participant's obligations in the system

Article 5

A transfer order may not be revoked by a participant in a system, nor by a third party, from the moment defined by the rules of that system

SECTION III

PROVISIONS CONCERNING INSOLVENCY PROCEEDINGS

Article 6

- 1 For the purpose of this Directive, the moment of opening of insolvency proceedings shall be the moment when the relevant judicial or administrative authority handed down its decision
- 2 When a decision has been taken in accordance with paragraph 1, the relevant judicial or administrative authority shall immediately notify that decision to the appropriate authority chosen by its Member State
- 3 The Member State referred to in paragraph 2 shall immediately notify other Member States

Article 7

Insolvency proceedings shall not have retroactive effects on the rights and obligations of a participant arising from, or in connection with, its participation in a system earlier than the moment of opening of such proceedings as defined in Article 6(1)

Article 8

In the event of insolvency proceedings being opened against a participant in a system, the rights and obligations arising from, or in connection with, the participation of that participant shall be determined by the law governing that system

SECTION IV

INSULATION OF THE RIGHTS OF HOLDERS OF COLLATERAL SECURITY FROM THE EFFECTS OF THE INSOLVENCY OF THE PROVIDER

Article 9

- 1 The rights of
 - a participant to collateral security provided to it in connection with a system, and
 - central banks of the Member States or the future European central bank to collateral security provided to them,shall not be affected by insolvency proceedings against the participant or counterparty to central banks of the Member States or the future European central bank which provided the collateral security. Such collateral security may be realised for the satisfaction of these rights.
- 2 Where securities (including rights in securities) are provided as collateral security to participants and/or central banks of the Member States or the future European central bank as described in paragraph 1, and their right (or that of any nominee, agent or third party acting on their behalf) with respect to the securities is legally recorded on a register, account or centralised deposit system located in a Member State, the determination of the rights of such entities as holders of collateral security in relation to those securities shall be governed by the law of that Member State.

SECTION V

FINAL PROVISIONS

Article 10

Member States shall specify the systems which are to be included in the scope of this Directive and shall notify them to the Commission and inform the Commission of the authorities they have chosen in accordance with Article 6(2)

The system shall indicate to the Member State whose law is applicable the participants in the system, including any possible indirect participants, as well as any change in them

In addition to the indication provided for in the second subparagraph, Member States may impose supervision or authorisation requirements on systems which fall under their jurisdiction

Anyone with a legitimate interest may require an institution to inform him of the systems in which it participates and to provide information about the main rules governing the functioning of those systems

Article 11

- 1 Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive before 11 December 1999. They shall forthwith inform the Commission thereof.
When Member States adopt these measures, they shall contain a reference to this Directive or shall be accompanied by such reference on the occasion of their official publication. The methods of making such a reference shall be laid down by the Member States.
- 2 Member States shall communicate to the Commission the text of the provisions of domestic law which they adopt in the field governed by this Directive. In this Communication, Member States shall provide a table of correspondence showing the national provisions which exist or are introduced in respect of each Article of this Directive.

Article 12

No later than three years after the date mentioned in Article 11(1), the Commission shall present a report to the European Parliament and the Council on the application of this Directive, accompanied where appropriate by proposals for its revision.

Article 13

This Directive shall enter into force on the day of its publication in the Official Journal of the European Communities.

Article 14

This Directive is addressed to the Member States.

Done at Brussels, 19 May 1998

For the European Parliament

The President
J M GIL-ROBLES

For the Council

The President
G BROWN

APPENDIX II

TEXT OF THE COLLATERAL DIRECTIVE

**DIRECTIVE 2002/47/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL
of 6 June 2002 on financial collateral arrangements**

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 95 thereof,

Having regard to the proposal from the Commission¹,

Having regard to the opinion of the European Central Bank²,

Having regard to the opinion of the Economic and Social Committee³,

Acting in accordance with the procedure laid down in Article 251 of the Treaty⁴,

Whereas:

- (1) Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems⁵ constituted a milestone in establishing a sound legal framework for payment and securities settlement systems. Implementation of that Directive has demonstrated the importance of limiting systemic risk inherent in such systems stemming from the different influence of several jurisdictions, and the benefits of common rules in relation to collateral constituted to such systems.
- (2) In its communication of 11 May 1999 to the European Parliament and to the Council on financial services: implementing the framework for financial markets: action plan, the Commission undertook, after consultation with market experts and national authorities, to work on further proposals for legislative action on collateral urging further progress in the field of collateral, beyond Directive 98/26/EC.
- (3) A Community regime should be created for the provision of securities and cash as collateral under both security interest and title transfer structures including repurchase agreements (repos). This will contribute to the integration and cost-efficiency of the financial market as well as to the stability of the financial system in the Community, thereby supporting the freedom to provide services and the free movement of capital in the single market in financial services. This Directive focuses on bilateral financial collateral arrangements.

1 OJ C 180 E, 26.6.2001, p. 312.

2 OJ C 196, 12.7.2001, p. 10.

3 OJ C 48, 21.2.2002, p. 1.

4 Opinion of the European Parliament of 13 December 2001 (not yet published in the Official Journal), Council Common Position of 5 March 2002 (not yet published in the Official Journal) and Decision of the European Parliament of 15 May 2002.

5 OJ L 166, 11.6.1998, p. 45.

- (4) This Directive is adopted in a European legal context which consists in particular of the said Directive 98/26/EC as well as Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions⁶, Directive 2001/17/EC of the European Parliament and of the Council of 19 March 2001 on the reorganisation and winding-up of insurance undertakings⁷ and Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings⁸. This Directive is in line with the general pattern of these previous legal acts and is not opposed to it. Indeed, this Directive complements these existing legal acts by dealing with further issues and going beyond them in connection with particular matters already dealt with by these legal acts.
- (5) In order to improve the legal certainty of financial collateral arrangements, Member States should ensure that certain provisions of insolvency law do not apply to such arrangements, in particular, those that would inhibit the effective realisation of financial collateral or cast doubt on the validity of current techniques such as bilateral close-out netting, the provision of additional collateral in the form of top-up collateral and substitution of collateral.
- (6) This Directive does not address rights which any person may have in respect of assets provided as financial collateral, and which arise otherwise than under the terms of the financial collateral arrangement and otherwise than on the basis of any legal provision or rule of law arising by reason of the commencement or continuation of winding-up proceedings or reorganisation measures, such as restitution arising from mistake, error or lack of capacity.
- (7) The principle in Directive 98/26/EC, whereby the law applicable to book entry securities provided as collateral is the law of the jurisdiction where the relevant register, account or centralised deposit system is located, should be extended in order to create legal certainty regarding the use of such securities held in a cross-border context and used as financial collateral under the scope of this Directive.
- (8) The *lex rei sitae* rule, according to which the applicable law for determining whether a financial collateral arrangement is properly perfected and therefore good against third parties is the law of the country where the financial collateral is located, is currently recognised by all Member States. Without affecting the application of this Directive to directly-held securities, the location of book entry securities provided as financial collateral and held through one or more intermediaries should be determined. If the collateral taker has a valid and effective collateral arrangement according to the governing law of the country in which the relevant account is maintained, then the validity against any competing title or interest and the enforceability of the collateral should be governed solely by the law of that country, thus preventing legal uncertainty as a result of other unforeseen legislation.
- (9) In order to limit the administrative burdens for parties using financial collateral under the scope of this Directive, the only perfection requirement which national law may impose in respect of financial collateral should be that the financial collateral is

6 OJ L 125, 5.5.2001, p. 15.

7 OJ L 110, 20.4.2001, p. 28.

8 OJ L 160, 30.6.2000, p. 1.

delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker or of a person acting on the collateral taker's behalf while not excluding collateral techniques where the collateral provider is allowed to substitute collateral or to withdraw excess collateral

- (10) For the same reasons, the creation, validity, perfection, enforceability or admissibility in evidence of a financial collateral arrangement, or the provision of financial collateral under a financial collateral arrangement, should not be made dependent on the performance of any formal act such as the execution of any document in a specific form or in a particular manner, the making of any filing with an official or public body or registration in a public register, advertisement in a newspaper or journal, in an official register or publication or in any other matter, notification to a public officer or the provision of evidence in a particular form as to the date of execution of a document or instrument, the amount of the relevant financial obligations or any other matter. This Directive must however provide a balance between market efficiency and the safety of the parties to the arrangement and third parties, thereby avoiding *inter alia* the risk of fraud. This balance should be achieved through the scope of this Directive covering only those financial collateral arrangements which provide for some form of dispossession, i.e. the provision of the financial collateral, and where the provision of the financial collateral can be evidenced in writing or in a durable medium, ensuring thereby the traceability of that collateral. For the purpose of this Directive, acts required under the law of a Member State as conditions for transferring or creating a security interest on financial instruments, other than book entry securities, such as endorsement in the case of instruments to order, or recording on the issuer's register in the case of registered instruments, should not be considered as formal acts.
- (11) Moreover, this Directive should protect only financial collateral arrangements which can be evidenced. Such evidence can be given in writing or in any other legally enforceable manner provided by the law which is applicable to the financial collateral arrangement.
- (12) The simplification of the use of financial collateral through the limitation of administrative burdens promotes the efficiency of the cross-border operations of the European Central Bank and the national central banks of Member States participating in the economic and monetary union, necessary for the implementation of the common monetary policy. Furthermore, the provision of limited protection of financial collateral arrangements from some rules of insolvency law in addition supports the wider aspect of the common monetary policy, where the participants in the money market balance the overall amount of liquidity in the market among themselves, by cross-border transactions backed by collateral.
- (13) This Directive seeks to protect the validity of financial collateral arrangements which are based upon the transfer of the full ownership of the financial collateral, such as by eliminating the so-called re-characterisation of such financial collateral arrangements (including repurchase agreements) as security interests.
- (14) The enforceability of bilateral close-out netting should be protected, not only as an enforcement mechanism for title transfer financial collateral arrangements including repurchase agreements but more widely, where close-out netting forms part of a

financial collateral arrangement. Sound risk management practices commonly used in the financial market should be protected by enabling participants to manage and reduce their credit exposures arising from all kinds of financial transactions on a net basis, where the credit exposure is calculated by combining the estimated current exposures under all outstanding transactions with a counterparty, setting off reciprocal items to produce a single aggregated amount that is compared with the current value of the collateral.

- (15) This Directive should be without prejudice to any restrictions or requirements under national law on bringing into account claims, on obligations to set-off, or on netting, for example relating to their reciprocity or the fact that they have been concluded prior to when the collateral taker knew or ought to have known of the commencement (or of any mandatory legal act leading to the commencement) of winding-up proceedings or reorganisation measures in respect of the collateral provider.
- (16) The sound market practice favoured by regulators whereby participants in the financial market use top-up financial collateral arrangements to manage and limit their credit risk to each other by mark-to-market calculations of the current market value of the credit exposure and the value of the financial collateral and accordingly ask for top-up financial collateral or return the surplus of financial collateral should be protected against certain automatic avoidance rules. The same applies to the possibility of substituting for assets provided as financial collateral other assets of the same value. The intention is merely that the provision of top-up or substitution financial collateral cannot be questioned on the sole basis that the relevant financial obligations existed before that financial collateral was provided, or that the financial collateral was provided during a prescribed period. However, this does not prejudice the possibility of questioning under national law the financial collateral arrangement and the provision of financial collateral as part of the initial provision, top-up or substitution of financial collateral, for example where this has been intentionally done to the detriment of the other creditors (this covers *inter alia* actions based on fraud or similar avoidance rules which may apply in a prescribed period).
- (17) This Directive provides for rapid and non-formalistic enforcement procedures in order to safeguard financial stability and limit contagion effects in case of a default of a party to a financial collateral arrangement. However, this Directive balances the latter objectives with the protection of the collateral provider and third parties by explicitly confirming the possibility for Member States to keep or introduce in their national legislation an *a posteriori* control which the Courts can exercise in relation to the realisation or valuation of financial collateral and the calculation of the relevant financial obligations. Such control should allow for the judicial authorities to verify that the realisation or valuation has been conducted in a commercially reasonable manner.
- (18) It should be possible to provide cash as collateral under both title transfer and secured structures respectively protected by the recognition of netting or by the pledge of cash collateral. Cash refers only to money which is represented by a credit to an account, or similar claims on repayment of money (such as money market deposits), thus explicitly excluding banknotes.

- (19) This Directive provides for a right of use in case of security financial collateral arrangements, which increases liquidity in the financial market stemming from such reuse of 'pledged' securities. This reuse however should be without prejudice to national legislation about separation of assets and unfair treatment of creditors.
- (20) This Directive does not prejudice the operation and effect of the contractual terms of financial instruments provided as financial collateral, such as rights and obligations and other conditions contained in the terms of issue and any other rights and obligations and other conditions which apply between the issuers and holders of such instruments.
- (21) This Act complies with the fundamental rights and follows the principles laid down in particular in the Charter of Fundamental Rights of the European Union.
- (22) Since the objective of the proposed action, namely to create a minimum regime relating to the use of financial collateral, cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale and effects of the action, be better achieved at Community level, the Community may adopt measures, in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty. In accordance with the principle of proportionality, as set out in that Article, this Directive does not go beyond what is necessary in order to achieve that objective,

HAVE ADOPTED THIS DIRECTIVE:

Article 1

Subject matter and scope

- 1. This Directive lays down a Community regime applicable to financial collateral arrangements which satisfy the requirements set out in paragraphs 2 and 5 and to financial collateral in accordance with the conditions set out in paragraphs 4 and 5.
- 2. The collateral taker and the collateral provider must each belong to one of the following categories:
 - (a) a public authority (excluding publicly guaranteed undertakings unless they fall under points (b) to (e)) including:
 - (i) public sector bodies of Member States charged with or intervening in the management of public debt, and
 - (ii) public sector bodies of Member States authorised to hold accounts for customers;
 - (b) a central bank, the European Central Bank, the Bank for International Settlements, a multilateral development bank as defined in Article 1(19) of Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions⁹, the International Monetary Fund and the European Investment Bank;

9 OJ L 126, 26.5.2000, p. 1. Directive as amended by Directive 2000/28/EC (OJ L 275, 27.10.2000, p. 37).

- (c) a financial institution subject to prudential supervision including
 - (i) a credit institution as defined in Article 1(1) of Directive 2000/12/EC, including the institutions listed in Article 2(3) of that Directive,
 - (ii) an investment firm as defined in Article 1(2) of Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field¹⁰,
 - (iii) a financial institution as defined in Article 1(5) of Directive 2000/12/EC,
 - (iv) an insurance undertaking as defined in Article 1(a) of Council Directive 92/49/EEC of 18 June 1992 on the coordination of laws, regulations and administrative provisions relating to direct insurance other than life assurance¹¹ and a life assurance undertaking as defined in Article 1(a) of Council Directive 92/96/EEC of 10 November 1992 on the coordination of laws, regulations and administrative provisions relating to direct life assurance¹²,
 - (v) an undertaking for collective investment in transferable securities (UCITS) as defined in Article 1(2) of Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)¹³,
 - (vi) a management company as defined in Article 1a(2) of Directive 85/611/EEC,
 - (d) a central counterparty, settlement agent or clearing house, as defined respectively in Article 2(c), (d) and (e) of Directive 98/26/EC, including similar institutions regulated under national law acting in the futures, options and derivatives markets to the extent not covered by that Directive, and a person, other than a natural person, who acts in a trust or representative capacity on behalf of any one or more persons that includes any bondholders or holders of other forms of securitised debt or any institution as defined in points (a) to (d),
 - (e) a person other than a natural person, including unincorporated firms and partnerships, provided that the other party is an institution as defined in points (a) to (d)
- 3 Member States may exclude from the scope of this Directive financial collateral arrangements where one of the parties is a person mentioned in paragraph 2(e) If they make use of this option Member States shall inform the Commission which shall inform the other Member States thereof
- 4 (a) The financial collateral to be provided must consist of cash or financial instruments
- (b) Member States may exclude from the scope of this Directive financial collateral consisting of the collateral provider's own shares, shares in affiliated undertakings within the meaning of seventh Council Directive 83/349/EEC of 13 June 1983 on consolidated accounts¹⁴, and shares in undertakings whose exclusive

10 OJ L 141, 11 6 1993, p 27 Directive as last amended by Directive 2000/64/EC of the European Parliament and of the Council (OJ L 290, 17 11 2000, p 27)

11 OJ L 228, 11 8 1992, p 1 Directive as last amended by Directive 2000/64/EC of the European Parliament and of the Council

12 OJ L 360, 9 12 1992, p 1 Directive as last amended by Directive 2000/64/EC of the European Parliament and of the Council

13 OJ L 375, 31 12 1985, p 3 Directive as last amended by Directive 2001/108/EC of the European Parliament and of the Council (OJ L 41, 13 2 2002, p 35)

14 OJ L 193, 18 7 1983, p 1 Directive as last amended by Directive 2001/65/EC of the European Parliament and of the Council (OJ L 283, 27 10 2001, p 28)

purpose is to own means of production that are essential for the collateral provider's business or to own real property

- 5 This Directive applies to financial collateral once it has been provided and if that provision can be evidenced in writing

The evidencing of the provision of financial collateral must allow for the identification of the financial collateral to which it applies. For this purpose, it is sufficient to prove that the book entry securities collateral has been credited to, or forms a credit in, the relevant account and that the cash collateral has been credited to, or forms a credit in, a designated account.

This Directive applies to financial collateral arrangements if that arrangement can be evidenced in writing or in a legally equivalent manner.

Article 2

Definitions

- 1 For the purpose of this Directive

- (a) 'financial collateral arrangement' means a title transfer financial collateral arrangement or a security financial collateral arrangement whether or not these are covered by a master agreement or general terms and conditions,
- (b) 'title transfer financial collateral arrangement' means an arrangement, including repurchase agreements, under which a collateral provider transfers full ownership of financial collateral to a collateral taker for the purpose of securing or otherwise covering the performance of relevant financial obligations,
- (c) 'security financial collateral arrangement' means an arrangement under which a collateral provider provides financial collateral by way of security in favour of, or to, a collateral taker, and where the full ownership of the financial collateral remains with the collateral provider when the security right is established,
- (d) 'cash' means money credited to an account in any currency, or similar claims for the repayment of money, such as money market deposits,
- (e) 'financial instruments' means shares in companies and other securities equivalent to shares in companies and bonds and other forms of debt instruments if these are negotiable on the capital market, and any other securities which are normally dealt in and which give the right to acquire any such shares, bonds or other securities by subscription, purchase or exchange or which give rise to a cash settlement (excluding instruments of payment), including units in collective investment undertakings, money market instruments and claims relating to or rights in or in respect of any of the foregoing,
- (f) 'relevant financial obligations' means the obligations which are secured by a financial collateral arrangement and which give a right to cash settlement and/or delivery of financial instruments.

Relevant financial obligations may consist of or include

- (i) present or future, actual or contingent or prospective obligations (including such obligations arising under a master agreement or similar arrangement),
- (ii) obligations owed to the collateral taker by a person other than the collateral provider, or
- (iii) obligations of a specified class or kind arising from time to time,

- (g) 'book entry securities collateral' means financial collateral provided under a financial collateral arrangement which consists of financial instruments, title to which is evidenced by entries in a register or account maintained by or on behalf of an intermediary,
- (h) 'relevant account' means in relation to book entry securities collateral which is subject to a financial collateral arrangement, the register or account - which may be maintained by the collateral taker - in which the entries are made by which that book entry securities collateral is provided to the collateral taker,
- (i) 'equivalent collateral'
 - (i) in relation to cash, means a payment of the same amount and in the same currency,
 - (ii) in relation to financial instruments, means financial instruments of the same issuer or debtor, forming part of the same issue or class and of the same nominal amount, currency and description or, where a financial collateral arrangement provides for the transfer of other assets following the occurrence of any event relating to or affecting any financial instruments provided as financial collateral, those other assets,
- (j) 'winding-up proceedings' means collective proceedings involving realisation of the assets and distribution of the proceeds among the creditors, shareholders or members as appropriate, which involve any intervention by administrative or judicial authorities, including where the collective proceedings are terminated by a composition or other analogous measure, whether or not they are founded on insolvency or are voluntary or compulsory,
- (k) 'reorganisation measures' means measures which involve any intervention by administrative or judicial authorities which are intended to preserve or restore the financial situation and which affect pre-existing rights of third parties, including but not limited to measures involving a suspension of payments, suspension of enforcement measures or reduction of claims,
- (l) 'enforcement event' means an event of default or any similar event as agreed between the parties on the occurrence of which, under the terms of a financial collateral arrangement or by operation of law, the collateral taker is entitled to realise or appropriate financial collateral or a close-out netting provision comes into effect,
- (m) 'right of use' means the right of the collateral taker to use and dispose of financial collateral provided under a security financial collateral arrangement as the owner of it in accordance with the terms of the security financial collateral arrangement,
- (n) 'close-out netting provision' means a provision of a financial collateral arrangement, or of an arrangement of which a financial collateral arrangement forms part, or, in the absence of any such provision, any statutory rule by which, on the occurrence of an enforcement event, whether through the operation of netting or set-off or otherwise
 - (i) the obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value, or are terminated and replaced by an obligation to pay such an amount, and/or
 - (ii) an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party

- 2 References in this Directive to financial collateral being provided', or to the 'provision of financial collateral, are to the financial collateral being delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker or of a person acting on the collateral taker's behalf. Any right of substitution or to withdraw excess financial collateral in favour of the collateral provider shall not prejudice the financial collateral having been provided to the collateral taker as mentioned in this Directive.
- 3 References in this Directive to 'writing' include recording by electronic means and any other durable medium.

Article 3

Formal requirements

- 1 Member States shall not require that the creation, validity, perfection, enforceability or admissibility in evidence of a financial collateral arrangement or the provision of financial collateral under a financial collateral arrangement be dependent on the performance of any formal act.
- 2 Paragraph 1 is without prejudice to the application of this Directive to financial collateral only once it has been provided and if that provision can be evidenced in writing and where the financial collateral arrangement can be evidenced in writing or in a legally equivalent manner.

Article 4

Enforcement of financial collateral arrangements

- 1 Member States shall ensure that on the occurrence of an enforcement event, the collateral taker shall be able to realise in the following manners, any financial collateral provided under, and subject to the terms agreed in, a security financial collateral arrangement:
 - (a) financial instruments by sale or appropriation and by setting off their value against, or applying their value in discharge of, the relevant financial obligations,
 - (b) cash by setting off the amount against or applying it in discharge of the relevant financial obligations.
- 2 Appropriation is possible only if:
 - (a) this has been agreed by the parties in the security financial collateral arrangement, and
 - (b) the parties have agreed in the security financial collateral arrangement on the valuation of the financial instruments.
- 3 Member States which do not allow appropriation on 27 June 2002 are not obliged to recognise it. If they make use of this option, Member States shall inform the Commission which in turn shall inform the other Member States thereof.

- 4 The manners of realising the financial collateral referred to in paragraph 1 shall, subject to the terms agreed in the security financial collateral arrangement, be without any requirement to the effect that
 - (a) prior notice of the intention to realise must have been given,
 - (b) the terms of the realisation be approved by any court, public officer or other person,
 - (c) the realisation be conducted by public auction or in any other prescribed manner, or
 - (d) any additional time period must have elapsed
- 5 Member States shall ensure that a financial collateral arrangement can take effect in accordance with its terms notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of the collateral provider or collateral taker
- 6 This Article and Articles 5, 6 and 7 shall be without prejudice to any requirements under national law to the effect that the realisation or valuation of financial collateral and the calculation of the relevant financial obligations must be conducted in a commercially reasonable manner

Article 5

Right of use of financial collateral under security financial collateral arrangements

- 1 If and to the extent that the terms of a security financial collateral arrangement so provide, Member States shall ensure that the collateral taker is entitled to exercise a right of use in relation to financial collateral provided under the security financial collateral arrangement
- 2 Where a collateral taker exercises a right of use, he thereby incurs an obligation to transfer equivalent collateral to replace the original financial collateral at the latest on the due date for the performance of the relevant financial obligations covered by the security financial collateral arrangement
Alternatively, the collateral taker shall, on the due date for the performance of the relevant financial obligations, either transfer equivalent collateral, or, if and to the extent that the terms of a security financial collateral arrangement so provide, set off the value of the equivalent collateral against or apply it in discharge of the relevant financial obligations
- 3 The equivalent collateral transferred in discharge of an obligation as described in paragraph 2, first subparagraph, shall be subject to the same security financial collateral agreement to which the original financial collateral was subject and shall be treated as having been provided under the security financial collateral arrangement at the same time as the original financial collateral was first provided
- 4 Member States shall ensure that the use of financial collateral by the collateral taker according to this Article does not render invalid or unenforceable the rights of the collateral taker under the security financial collateral arrangement in relation to the financial collateral transferred by the collateral taker in discharge of an obligation as described in paragraph 2, first subparagraph

5. If an enforcement event occurs while an obligation as described in paragraph 2 first subparagraph remains outstanding, the obligation may be the subject of a close-out netting provision.

Article 6

Recognition of title transfer financial collateral arrangements

1. Member States shall ensure that a title transfer financial collateral arrangement can take effect in accordance with its terms.
2. If an enforcement event occurs while any obligation of the collateral taker to transfer equivalent collateral under a title transfer financial collateral arrangement remains outstanding, the obligation may be the subject of a close-out netting provision.

Article 7

Recognition of close-out netting provisions

1. Member States shall ensure that a close-out netting provision can take effect in accordance with its terms:
 - (a) notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of the collateral provider and/or the collateral taker; and/or
 - (b) notwithstanding any purported assignment, judicial or other attachment or other disposition of or in respect of such rights.
2. Member States shall ensure that the operation of a close-out netting provision may not be subject to any of the requirements that are mentioned in Article 4(4), unless otherwise agreed by the parties.

Article 8

Certain insolvency provisions disapplied

1. Member States shall ensure that a financial collateral arrangement, as well as the provision of financial collateral under such arrangement, may not be declared invalid or void or be reversed on the sole basis that the financial collateral arrangement has come into existence, or the financial collateral has been provided:
 - (a) on the day of the commencement of winding-up proceedings or reorganisation measures, but prior to the order or decree making that commencement; or
 - (b) in a prescribed period prior to, and defined by reference to, the commencement of such proceedings or measures or by reference to the making of any order or decree or the taking of any other action or occurrence of any other event in the course of such proceedings or measures.
2. Member States shall ensure that where a financial collateral arrangement or a relevant financial obligation has come into existence, or financial collateral has been provided on the day of, but after the moment of the commencement of, winding-up proceedings or reorganisation measures, it shall be legally enforceable and binding on third parties

if the collateral taker can prove that he was not aware, nor should have been aware, of the commencement of such proceedings or measures

- 3 Where a financial collateral arrangement contains
 - (a) an obligation to provide financial collateral or additional financial collateral in order to take account of changes in the value of the financial collateral or in the amount of the relevant financial obligations, or
 - (b) a right to withdraw financial collateral on providing, by way of substitution or exchange, financial collateral of substantially the same value,

Member States shall ensure that the provision of financial collateral, additional financial collateral or substitute or replacement financial collateral under such an obligation or right shall not be treated as invalid or reversed or declared void on the sole basis that

- (i) such provision was made on the day of the commencement of winding-up proceedings or reorganisation measures, but prior to the order or decree making that commencement or in a prescribed period prior to, and defined by reference to, the commencement of winding-up proceedings or reorganisation measures or by reference to the making of any order or decree or the taking of any other action or occurrence of any other event in the course of such proceedings or measures, and/or
 - (ii) the relevant financial obligations were incurred prior to the date of the provision of the financial collateral, additional financial collateral or substitute or replacement financial collateral
- 4 Without prejudice to paragraphs 1, 2 and 3, this Directive leaves unaffected the general rules of national insolvency law in relation to the voidance of transactions entered into during the prescribed period referred to in paragraph 1(b) and in paragraph 3(i)

Article 9

Conflict of laws

- 1 Any question with respect to any of the matters specified in paragraph 2 arising in relation to book entry securities collateral shall be governed by the law of the country in which the relevant account is maintained. The reference to the law of a country is a reference to its domestic law, disregarding any rule under which, in deciding the relevant question, reference should be made to the law of another country
- 2 The matters referred to in paragraph 1 are
 - (a) the legal nature and proprietary effects of book entry securities collateral,
 - (b) the requirements for perfecting a financial collateral arrangement relating to book entry securities collateral and the provision of book entry securities collateral under such an arrangement, and more generally the completion of the steps necessary to render such an arrangement and provision effective against third parties,
 - (c) whether a person's title to or interest in such book entry securities collateral is overridden by or subordinated to a competing title or interest, or a good faith acquisition has occurred,

- (d) the steps required for the realisation of book entry securities collateral following the occurrence of an enforcement event.

Article 10

Report by the Commission

Not later than 27 December 2006, the Commission shall present a report to the European Parliament and the Council on the application of this Directive, in particular on the application of Article 1(3), Article 4(3) and Article 5, accompanied where appropriate by proposals for its revision.

Article 11

Implementation

Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive by 27 December 2003 at the latest. They shall forthwith inform the Commission thereof.

When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such reference on the occasion of their official publication. Member States shall determine how such reference is to be made.

Article 12

Entry into force

This Directive shall enter into force on the day of its publication in the Official Journal of the European Communities.

Article 13

Addressees

This Directive is addressed to the Member States.

Done at Brussels, 6 June 2002.

For the European Parliament

The President
P. COX

For the Council

The President
A. M. BIRULÉS Y BERTRÁN

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LEGISLATION, GUIDELINES AND PRINCIPLES

Collateral Directive

Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, *Official Journal* L168, 27 June 2002, pp 43-50

The Collateral Directive contains rules in respect of collateralised arrangements, such as repos and securities lending transactions. The directive is intended to enhance the liquidity of the European cash and securities markets by harmonising the national legal regimes in respect of collateralised arrangements.

German Civil Code

The German Civil Code was introduced in 1900. It is a uniform regulation that is applicable in all German territories. Before 1900, each German territory had its own rules of civil law, whereas Roman law, particularly as interpreted by the Pandectists (*Pandektisten*), had a certain unifying effect.

Guideline ECB/2000/1

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March 2005 Amendment to Guideline ECB/2000/1

Guideline of the European Central Bank of 11 March 2005 amending Guideline ECB/2000/1 on the management of the foreign reserve assets of the European Central Bank by the national central banks and the legal documentation for operations involving the foreign reserve assets of the European Central Bank, (ECB/2005/6), *Official Journal* L 109, 29 April 2005, pp 107-109

December 2005 Amendment to Guideline ECB/2000/1

Guideline of the European Central Bank of 15 December 2005 amending Guideline ECB/2000/1 on the management of the foreign reserve assets of the European Central Bank by the national central banks and the legal documentation for operations involving the foreign reserve assets of the European Central Bank, (ECB/2005/15), *Official Journal* L 345, 28 December 2005, pp 33-34

Guideline ECB/2000/1 and the amendments thereto of June and November 2001, September 2002, and March and December 2005 contain regulations by which National Central Banks must abide in managing the foreign reserve assets of the European Central Bank

Netherlands Civil Code

In 1947, the process that ultimately led to the recodification of the Netherlands Civil Code of 1838 began. The first books of the current Netherlands Civil Code were introduced in 1970. The core of the current Civil Code, i.e. Books 3, 5 and 6 relating to property and contract law, took effect on the 1 January 1992. There are still some issues that need to be resolved.¹

Netherlands Bankruptcy Code

The Netherlands Bankruptcy Code came into force in 1896. It contains rules relating to bankruptcy procedures aimed at liquidation (*faillissement*), suspension of payment procedures aimed at continuation (*surseance van betaling*), and special rules relating to individual persons (*schuldsanering natuurlijke personen*).²

1 For an overview in English of the civil law revision in the Netherlands, see Hartkamp in the Netherlands Business Legislation.

2 At present, an advisory committee on insolvency law (*Commissie Insolventierecht*), appointed by the Dutch Minister of Justice, is working on a proposal for a thorough revision of the Dutch Bankruptcy Code. For more information, see www.justitie.nl.

Principles of European Contract Law

The European Principles have been drawn up by the Commission on European Contract Law, which is an independent body of experts from the Member States of the European Union. The Principles of European Contract Law consist of three parts. Parts I and II cover the core rules of contract, formation, authority of agents, validity, interpretation, contents, performance, non-performance (breach) and remedies. Part III covers plurality of parties, assignment of claims, substitution of new debt, transfer of contract, set-off, prescription, illegality, conditions and capitalisation of interest.³

Settlement Finality Directive

Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on Settlement Finality in Payment and Securities Settlement Systems, *Official Journal L* 166, 11 June 1998, pp 45-50

The Settlement Finality Directive concerns bookings of cash and securities which are carried out in so-called settlement systems. Basically, a settlement system consists of an intermediary (or intermediaries) that net and/or settle the booking orders of participants in the system. The Settlement Finality Directive is intended to guarantee the legal enforceability of such netting and settlements.

Statute of the ESCB and the ECB

Protocol (No 18) (ex No 3) to the Treaty Establishing the European Community on the Statute of the European System of Central Banks and of the European Central Bank

The Statute of the European System of Central Banks and of the European Central Bank, among other things, contains provisions on the objectives, organisation and different activities of these institutions.

UNIDROIT Preliminary Draft Convention on Substantive Rules regarding Intermediated Securities

The International Institute for the Unification of Private Law (UNIDROIT) is an independent intergovernmental organisation based in Rome. Its purpose is to study needs and methods for modernising, harmonising and co-ordinating private and, in particular, commercial law between States and groups of States. In the course of a project on Transactions on transnational and connected capital markets, UNIDROIT is currently developing a Convention on Substantive Rules regarding Intermediated Securities.

UNIDROIT Principles of International Commercial Contracts

Another UNIDROIT initiative concerns Principles of International Commercial Contracts. A first set of these UNIDROIT Principles was developed by a special Working Group and published in 1994. A second set of Principles, covering a number of additional topics, has been approved by the UNIDROIT Governing Council in April 2004.

3 See www.cbs.dk/departments/law/staff/ol/commission_on_ecl/

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European Commission, Financial Markets Infrastructure	http://europa.eu.int/comm/ internal_market/financial- markets/index_en.htm
European Financial Market Lawyers Group	www.efmlg.org
European Repo Council	www.icma-group.org
International Swaps and Derivatives Association	www.isda.org
International Capital Market Association	www.icma-group.org
International Securities Lenders Association	www.isla.co.uk
The Bond Market Association	www.bondmarkets.com
UNIDROIT	www.unidroit.org

SUBJECT INDEX

References below are to chapter(section). References in bold indicate sections in which the subject concerned is discussed extensively. If the subject is mentioned in a footnote, the reference will appear as follows: chapter(section, n.).

A	
Actio pauliana	See Voidable preference
Accounting	I(3), IV(1.4.2), IV(2.6), IV(3.5), IV(5.4) , IV(5.5), VI(2.2.4.a)
Adjustment	II(4.3.2.b) , II(4.3.3, n.40), II(4.4), III(2.6.2)
Appropriation	I(3), II(8.7.2) , II(9.4.1), III(1.3) , III(3.2.2.c), III(3.2.3.d), III(3.3.2.b) , III(3.3.3.b), III(3.4.1.a), III(3.4.1.d), III(3.4.2.a), III(3.4.2.b), III(3.7.1), III(3.7.2), III(5.2), IV(1.3.1), IV(4.3.2), IV(4.5.5.b), IV(4.9), IV(5.2.1), IV(5.2.4), IV(5.2.7), V(1.2), V(2) , V(6.1.1), VI(2.2.2), VI(2.2.3.a), VI(2.2.4.a), VI(2.2.4.b), VI(3.3.2), VI(3.3.4)
B	
Benefits	
equitable rule of no collateral –	IV(3.4.3) , IV(3.4.6), IV(3.7), IV(5.2.3.a), IV(5.2.7)
Bridge provision	II(5.1), II(5.2) , II(5.5)
C	
Capital adequacy	I(3), II(5.5), IV(1.4.2), IV(2.6), IV(3.5), IV(5.4) , IV(5.5), VI(2.2.4.a)
Care	
duty of –	III(1.3) , IV(1.3.1), IV(2.4.3) , IV(2.4.4), IV(2.5), IV(2.6), IV(4.3.2), IV(4.5.5.b), IV(4.9), IV(5.2.1), IV(5.2.2), IV(5.2.4), IV(5.2.7), VI(2.2.2), VI(2.2.4.a)
Central bank	I(1), I(2), II(5.4.1), II(6.2), II(6.3), II(7) , III(3.6.1), VI(1.1), VI(3.2)
Close-out netting	II(4.7) , II(5.1), II(5.2), II(5.4), II(8.1), II(8.7.1), II(8.7.3) , II(8.9), II(9.4.2) , III(3.3.3.b), III(3.4.3.a), IV(1.3.1), IV(2.4.4), IV(3.5), V(1.2), V(3) , V(5.3), V(5.4), V(5.5), V(6.1.2) , VI(2.2.3.b) , VI(2.3.3), VI(4.4)
Commensurability	See Similarity
Commission	
sale on –	See Sale
Condition	
– precedent	III(4.1), IV(4.6.5)
– subsequent	III(3.2.2.c), III(3.2.3.d), III(4.1)
Contrat cadre de prêts de titres	II(3.3)
Convention-cadre	II(3.2), II(3.4)
CPMA	See Cross-Product Master Agreement

- Credit Support Documents See International Swaps and Derivatives Association
- Cross-product **II(5)**, **II(7.3)**, **III(3.6.5)**, **III(3.6.8)**
- Cross-Product Master Agreement **II(5.1)**, **II(5.4)**, **II(5.5)**
- Currency swap See Swap
- D**
- Delivery
- constitutum possessorium **III(3.2.2.b)**, **III(3.2.2.c)**, **III(3.2.3.c)**, **III(3.6.2)**
 - longa manu **III(3.2.2.b)**
- De Nederlandsche Bank **III(3.6.1)**
- Deposit facilities **II(7.2.1.d)**, **II(7.2.2.b)**
- Derivatives **II(2.2.3)**, **II(3.4)**, **IV(2.3)**
- See also International Swaps and Derivatives Association, Swap
- DNB See De Nederlandsche Bank
- E**
- ECB See European Central Bank
- Economic and Monetary Union **II(7.1)**, **II(7.3)**, **III(3.6.1)**
- EMA See European Master Agreement
- EMU See Economic and Monetary Union
- Equitable principles
- equity of redemption See Redemption
 - no collateral benefits See Benefits
 - once a mortgage, always a mortgage See Mortgage
- Equity of redemption See Redemption
- ERC See European Repo Council
- European Banking Federation **II(5.3.2)**, **II(6.3)**, **IV(1.3.3)**
- European Central Bank **II(5.4.1)**, **II(6.3)**, **II(7)**, **III(3.6.1, n.133)**
- European Master Agreement **II(3.2)**, **II(3.3)**, **II(3.4)**, **II(5.1)**, **II(5.3)**, **II(5.5)**, **II(7.3)**, **III(2.2)**, **III(2.3)**, **IV(5.3)**, **V(3.5.6)**, **VI(3.3.4)**
- European Principles of Contract Law **V(3.2.4)**, **V(3.2.5)**, **V(3.3.3)**, **V(3.3.4)**
- European Repo Council **II(3.2)**, **II(8.6, n.137)**
- F**
- FBE See European Banking Federation
- Fédération Bancaire de l'Union Européenne See European Banking Federation
- Fine-tuning operations See Operations
- Fixation **V(3.5.3)**, **V(3.5.4)**, **V(3.5.5)**, **V(3.5.7)**, **V(3.5.8)**, **V(4.1, n.92)**, **V(4.2)**, **V(4.3.3.c)**, **V(4.3.3.d)**, **V(6.1.2)**, **V(6.2)**, **VI(2.3.1)**, **VI(2.3.2)**, **VI(4.5)**
- Foreign reserve assets **II(7.3)**
- Freeze period **II(8.8.4)**, **II(9.4.3)**, **V(5)**, **V(6.2.3)**, **VI(2.3.3)**, **VI(4.6)**
- G**
- Global Master Repurchase Agreement **II(3.2)**, **II(4)**
- Netherlands Annex to the – **III(3.5)**, **III(3.6.1)**, **III(3.6.7)**, **V(3.5.4)**
- Global Master Securities Lending Agreement **II(3.3)**, **II(4)**

GMRA	See Global Master Repurchase Agreement
GMSLA	See Global Master Securities Lending Agreement
H	
Haircut	See Margin ratio
Hire purchase	III(3 4 2 b)
I	
ICMA	See International Capital Market Association
Income payments	II(4 1), II(4.5), III(3 3 3 b), III(3 4 3 b), III(4 4), III(4 6), IV(1 4 1), IV(5 4), V(4 3 1)
Initial margin	II(4 2 1) See also Margin ratio
International Capital Market Association	II(3.2)
International Repo Council	II(3.2)
International Securities Lenders Association	II(3.3)
International Securities Market Association	II(3.2)
International Swaps and Derivatives Association	II(3.4), II(6 3), IV(1 3 3), VI(3 2 , n 15)
1994 – Credit Support Annex (New York law)	II(2 2), II(2 4 3), II(3 4), IV(2 3, n 46)
1995 – Credit Support Deed (English law)	II(2 2), II(2 4 3), II(3 4)
1995 – Credit Support Annex (English law)	II(2 2), II(3 4)
– Cross-Agreement Bridge	II(5.2), II(5 5)
– Margin Provisions	II(2 2), II(2 3), II(2 4 3), II(3 4), III(1 2), III(3 3 3 b), IV(2 3), IV(2 4 2), IV(2 4 5), IV(2 5), IV(3 3), IV(5 3)
– Master Agreements	II(2 2), II(3 4), II(5 3 1), II(7 3), III(3 3 3 b)
IRC	See International Repo Council
Irrregular	
– right of custody	III(2 4 2), III(2 6 1), IV(4 6), IV(4.6.2), IV(4 9), IV(5 2 3 b)
– right of pledge	III(2 4 2), III(2 6 1), IV(4 5 5 b), IV(4 6), IV(4.6.2), IV(4 7 2), IV(4 8), IV(4 9), IV(5 2 3 b), IV(5 2 7), VI(2 2 4 a)
– right of usufruct	III(2 4 2), III(2 6 1), IV(4 5 5 a), IV(4 6), IV(4 6 2), IV(4.6.3), IV(4 9), IV(5 2 3 b)
ISDA	See International Swaps and Derivatives Association
ISLA	See International Securities Lenders Association
ISMA	See International Securities Market Association
L	
Lease	III(3.4), III(5 2), V(5 4)
Lending fee	II(4 2 2), II(4 6 1)

- p>
Loan of fungibles III(2.4), III(2.5), III(2.6.1), III(2.8), III(3.6.4), IV(4.5.5.a), IV(4.6.2), IV(4.6.4.b), IV(4.9)
M
Margin
initial – See Initial margin
ISDA – Provisions See International Swaps and Derivatives Association
– maintenance II(4.1), II(4.3), II(5.3.2), II(8.5), III(2.2), III(2.6), III(3.3.3.b), III(3.4.3.b)
– ratio II(4.2.1), II(4.3.2.b), II(4.3.3) See also Initial margin
Master Equity & Fixed Interest Stock Lending Agreement II(3.3)
Master Gilt Edged Stock Lending Agreement II(3.3)
Master master agreement II(5.1), II(5.4), II(5.5)
MEFISLA See Master Equity & Fixed Interest Stock Lending Agreement
MGESLA See Master Gilt Edged Stock Lending Agreement
Minimum reserves II(7.2.1.b)
Mortgage
once a –, always a – IV(3.4.1), IV(3.4.2), IV(3.4.6), IV(3.7), IV(5.2.3.a), IV(5.2.7)
Mutuality See Reciprocity
N
Netherlands Annex See Global Master Repurchase Agreement
O
Open market operations See Operations
Operations
fine-tuning – II(7.2.2.a), II(7.2.2.c), II(7.2.2.d)
open market – II(7.2.1.a), II(7.2.1.b), II(7.2.1.c), II(7.2.2.a)
refinancing – II(7.2.2.a), II(7.2.2.b)
structural – II(7.2.2.a), II(7.2.2.d)
Opt-out clause II(8.2.2), II(8.2.4), II(8.7.2), VI(3.2)
OSLA See Overseas Securities Lender's Agreement
OTC See Over-the-counter
Overseas Securities Lender's Agreement II(3.3), IV(3.3)
Over-the-counter II(3.4), IV(1.3.2), IV(5.2.4), V(2.2.1.c), V(2.2.3), VI(2.2.4.b, n.9)
P
Pari passu IV(1.3.3), IV(4.1.2), IV(4.9), IV(5.2.3.b), V(3.1.1), V(4.3.2), V(4.3.3.c), V(4.3.3.d), V(6.2.2), VI(2.3.2), VI(4.5)
Paritas creditorum See Pari passu
Perishable goods IV(4.4), IV(4.7.4, n.192), IV(4.9), IV(5.2.3.b)

- Pledge
 irregular right of –
 re–
 subsidary right of –
 Price differential
 Pricing rate
 Prime broker
 Prohibition of appropriation
 Proprietary substitution
- R**
 Raamovereenkomst Financiële
 Derivaten
 Rahmenvertrag
 Reciprocity
 Redemption
 equity / right of –
 Refinancing operations
 Replaceability
 Repledge
 Repo rate
 Repricing
 Reservation of title
 Retroactive force
 Reverse transactions
- S**
 Sale on commission
 Similarity
 Standing facilities
 Structural operations
 Subsidiary right of pledge
 Substitution
 – of collateral
- See Irregular right of pledge
 IV(2.1), **IV(2.2)**, IV(2.3), IV(2.4.1.), IV(2.4.2),
 IV(2.4.3), IV(2.6), IV(3.1, n.66), **IV(4.3)**, IV(4.5.1.a),
 IV(4.5.5.b), IV(4.9), IV(5.2.2), IV(5.2.3.b)
 III(3.5), III(3.6.7), III(5.2)
 II(4.2.1), II(4.6.1)
 See also Repo rate
 See Repo rate
 IV(3.1), IV(3.2.1), **IV(3.2.2)**, IV(3.7)
 See Appropriation
 See Substitution
- II(3.4)
 II(3.2), II(3.3), II(3.4)
 II(8.7.3), V(3.1.3), V(3.1.4), **V(3.2)**, V(3.6), VI(4.4)
III(1.3), IV(2.2), **IV(2.4.2)**, IV(2.4.4), IV(2.5),
 IV(2.6), IV(3.2.2), IV(3.4.1), **IV(3.4.2)**, IV(3.4.4),
 IV(3.4.5), IV(3.4.6), IV(3.5), IV(3.7), IV(4.5.5.b),
 IV(4.6.4.d), IV(4.6.4.f), IV(4.9), IV(5.2.1), IV(5.2.2),
 IV(5.2.3), IV(5.2.4), IV(5.2.7), IV(5.5), VI(2.2.2),
 VI(2.2.4.a)
 See Operations
III(2.4.2), III(2.6.1), III(2.6.2), III(2.8), III(3.6.3),
 III(3.6.4), **IV(4.6.2)**, IV(4.6.3.e), IV(4.6.4.b),
 IV(4.6.4.c), IV(4.6.4.f), IV(4.9), IV(5.2.3.b),
 VI(2.2.4.a)
 See Pledge
 II(4.2.1), II(4.6.3), II(7.2.2.b)
 See also Price differential
II(4.3.2.b), II(4.3.3, n.40), **III(2.6.2)**
III(3.4.2.b), IV(4.5.1), **IV(4.5.3)**, IV(4.5.5),
 IV(4.6.5), IV(4.9), IV(5.2.3.b), V(5.4)
 II(8.5), II(8.6), II(8.8.1), **II(8.8.2)**, II(8.9), II(9.4.3),
 V(4.1), **V(4.2)**, V(6.2), **V(6.2.1)**, **VI(2.3.1)**, VI(2.4),
 VI(3.4), **VI(4.6)**
 II(2.2.1), II(7.1), **II(7.2)**
- IV(4.5.1), **IV(4.5.2)**, IV(4.5.3), IV(4.5.5.b), IV(4.9),
 IV(5.2.3.b)
 V(3.1.4), V(3.2.2), **V(3.3)**
II(7.2.1.d), II(7.2.2)
 See Operations
 See Pledge
II(4.4), **II(8.6)**, **III(2.7)**

proprietary –	IV(1.3.1), IV(2.4.5) , IV(3.4.5) , IV(4.4), IV(4.6.3.d), IV(4.7) , IV(4.8), IV(4.9), IV(5.2.3.b), VI(2.2.4.a), VI(4.3)
Surplus value	III(1.3) , III(3.2.2.c), III(3.2.3.d), III(3.3.2.c) , III(3.3.3.b), III(3.4.1), III(3.4.1.a), III(3.4.1.d), III(3.4.2), III(3.4.3.a), III(3.4.5), III(3.7.1), III(3.7.2), III(5.2), V(1.2), VI(2.2.2), VI(2.2.3.a), VI(3.3.2)
Swap	II(2.2.3), II(7.2.1.c), V(3.5.5) See also Derivatives, International Swaps and Derivatives Association
Systemic risk	II(8.7.2), V(2.2.2), V(4.2), V(4.3.3.a), V(4.3.3.d), V(5.3), V(6.2.3), VI(1.1), VI(1.4), VI(2.2.4.b), VI(2.3.2), VI(2.3.3), VI(2.4), VI(4.1), VI(4.4), VI(4.6)
T	
Tax	I(3), IV(1.4.3), IV(2.6), IV(3.5), IV(5.4), IV(5.5), V(5.2), V(5.4), VI(2.2.4.a)
TBMA	See The Bond Market Association
The Bond Market Association	II(3.2)
– Master Repurchase Loan Agreement	II(3.2), II(7.3), III(3.5), IV(2.1), VI(3.3.4)
– Master Securities Agreement	II(3.3), IV(2.3), IV(2.4.1), IV(2.5), VI(3.3.4)
Trust	III(1.2), IV(1.3.2), IV(1.3.3), IV(2.4.5), IV(3.2.3), IV(3.4.5)
U	
UNIDROIT	
– Draft Convention on Convention on Substantive Rules regarding Intermediated Securities	IV(1.1), IV(5.2.6), V(2.2.2), V(2.3, n.37), V(6.1.1), VI(2.2.4.b), VI(2.4, n.11)
– Principles of International Commercial Contracts	V(3.2.5) , V(3.2.6, n.58), V(3.3.4)
Unjustified enrichment	III(3.4.2.b)
V	
Voidable preference	II(8.7.3), II(9.4.3), III(3.4.2.b), V(3.1.3), V(3.3.6), V(3.4) , V(3.5.7), V(3.6), V(6.1.2), VI(2.2.3.b), VI(4.4)
Voting rights	III(3.3.3.b, n.87), III(3.4.3.b), III(4.4), III(4.6), IV(1.4.1), IV(5.4)
Z	
Zero hour rule	See Retroactive force

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