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French Transposition of the Collateral Directive

A Brief Overview

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EU COLLATERAL DIRECTIVE'S MAIN OBJECTIVES

EU COLLATERAL DIRECTIVE'S MAIN OBJECTIVES

- Creating a minimal unified legal regime across Europe
 - ◆ To enhance financial markets integration
 - ◆ To strengthen the EU financial system stability
- By requesting 7 main initiatives from Members States:-
 - ◆ To recognize two possible ways of collateralizing transactions:-
 - Fiduciary title transfers
 - Security interests / pledges
 - ◆ To protect a broad range of transactions (**Art 2(1)(f)**)
 - *"Relevant financial obligations means obligations which are secured by a financial collateral arrangement and which give a right to cash settlement and/or delivery of financial instruments (...) whether present or future, actual or contingent or prospective"*.
 - ◆ To limit formalism for the creation, validity, perfection, enforceability, admissibility of collateral arrangements and to permit rapid and non-formalistic enforcement
 - Impossibility to request execution of a formal document, the making of any filing with or notification to an official or public body, any public registration, publication or advertisement in a newspaper or journal
 - Only authorized perfection requirement: the actual delivery of the collateral so as to be in the possession or under the control of the collateral taker or of a person acting on its behalf

EU COLLATERAL DIRECTIVE'S MAIN OBJECTIVES

- ◆ To provide for a possible contractual creditor pledgee's right to re-use posted collateral
 - Increasing financial market liquidity
 - Subject to national legislations about separation of assets and unfair treatment of creditors
- ◆ To disapply certain provisions of insolvency law **AND** of civil or commercial execution proceedings to collateral arrangements
 - Rules casting doubts on the validity of usual market techniques, *e.g.* right of substitution
 - Rules inhibiting effective enforcement of collateral
- ◆ **To protect bilateral close-out netting mechanisms**
- ◆ To extend to all cross-border financial collateral, the conflict of laws rule set forth by EU Directive 98/26/EC for determining the law applicable to perfection requirements
 - *Lex rei sitae* rule is recognized by all Member States
 - The law applicable to book entry securities provided as collateral is the law of the jurisdiction where the relevant register, account or centralized deposit system is located

FORMER FRENCH FINANCIAL NETTING REGIME

FORMER FRENCH FINANCIAL NETTING REGIME

3 CONDITIONS OF APPLICABILITY

- Legal status of the parties
 - ◆ **One only** of the parties to the Agreement had to be an "*eligible counterparty*", *i.e.*
 - Credit establishment / investment firm
 - Public establishment (EPA, EPIC)
 - Entity of Art. L.531-2
 - *Trésor, Banque de France, IEOM and IEDOM, La Poste*
 - Insurance and reinsurance company
 - UCITS
 - FCC
 - Intra-group investment services provider
 - Commodity dealer
 - etc.
 - ◆ Does not need to be the French party
 - Eligibility of "*non resident establishment having a comparable status*"
 - Criteria of equivalence
 - Nature and extent of the local approvals or licensing
 - Prudential supervision
 - Regulatory or investment constraints
 - Control by similar regulatory authority
 - ◆ **Netting therefore already effective against French ordinary corporate**

FORMER FRENCH FINANCIAL NETTING REGIME

3 CONDITIONS OF APPLICABILITY

- Nature of transactions covered: "*transactions on financial instruments*"
 - ◆ Financial instruments (Art. L.211-1-I)
 - shares and other securities which give access directly or indirectly to the capital or voting rights and which are transferable by book-entry or by delivery
 - debt instruments which individually represent a claim against the issuing legal entity and which are transferable by book-entry or by delivery, excluding bills of exchange (*effets de commerce*) and cash vouchers (*bons de caisse*)
 - shares or units in collective investment undertakings
 - **forward financial instruments**
 - any instruments similar to those mentioned in the previous paragraphs issued under foreign law.
 - ◆ Forward financial instruments (Art. L.211-1-II)
 - Forward contracts on bills, notes, securities, indexes and currencies, including equivalent instruments giving rise to a cash settlement
 - Forward contracts on interest rates
 - Swaps
 - Forward contracts on commodities or greenhouse gas allowances, provided that they are either, further to their negotiation, cleared through a financial instruments clearing house, are the subject of periodic margin calls, or may be cash settled by the seller
 - Purchase or sale option contracts on financial instruments
 - **all other forward markets instruments**
 - ◆ Temporary transfers (repos, reverse repos, securities lending, etc.)

FORMER FRENCH FINANCIAL NETTING REGIME

3 CONDITIONS OF APPLICABILITY

■ Market Documentation

- ◆ Mandatory use of an agreement "*complying with the general principles of a national or international market master-agreements*"
- ◆ No statutory definition of "*market master agreement*"
 - But certain criteria
 - Approval by the French CMF (never applied!)
 - Approval by the *Banque de France* for supervisory recognition of net amounts
 - Widespread use on the market
 - Issuance / promotion by a professional association representing the main markets participants
 - Validation by legal opinions
 - Concept generally interpreted as including most industry standard master agreements
- ◆ No statutory definition of the "*general principles*"
 - May vary from a master agreement to another
 - Purpose of "core provisions" legal opinions
 - identify any provisions of an industry market master agreement that we regard as so essential that a material alteration thereof could affect the conclusions reached in the basis netting opinion (the "Core Provisions")
 - confirm that any inclusion of additional provisions or modification to a provision that is not a Core Provision would not affect such conclusions
 - confirm that certain specified alterations to selected Core Provisions would not affect such conclusions
- ◆ Exclusion of:-
 - Bespoke / internal agreements
 - Undocumented transactions

MAIN ADAPTATIONS AGREED BY FRENCH GOVERNMENT

WHY IS THE FRENCH OPT-OUT "MINI"?

MAIN ADAPTATIONS AGREED BY FRENCH GOVERNMENT

NETTING

- Close-out netting
 - ◆ Wider scope of transactions covered
 - "Relevant financial obligations" in practice means everything!
 - Need to reduce the scope if France wants to keep some substance to its insolvency laws
 - ... at least for French ordinary corporate
 - **Compromise: the French "mini opt-out"**
 - Same current "*transactions on financial instruments*" when at least one party is an eligible counterparty
 - Any "*financial obligations*", in the meaning of the Directive, between eligible counterparties
 - No limitation to collateralized transactions only
 - Protection going beyond the Directive for:-
 - Other types of collateral (not only cash and financial instruments but also bills, receivables or contracts)
 - Top-up collateral
 - Buffer collateral / Independent amounts
 - Over-collateralization
 - ◆ Wider scope of "*eligible counterparties*"
 - Local authorities
 - Clearing houses
 - International financial institutions or bodies which France or the EU is a member of
 - ◆ **Deletion of any documentation relating condition**

MAIN ADAPTATIONS AGREED BY FRENCH GOVERNMENT

COLLATERAL

- Collateral
 - ◆ Reducing security interest perfection and enforcement procedural requirements
 - Traditional French requirements were heavy for security interests over securities
 - But not for security interests over cash or fiduciary title transfers
 - ◆ Strengthening resistance of collateral arrangements, not only to bankruptcy law, but also to civil or commercial enforcement proceedings
 - ◆ Introducing under French law the right of "re-use" and fixing its accounting and tax neutrality regimes

IMPACTS ON ISDA OPINIONS

ENTITIES COVERED

- Broader scope of entities covered (e.g. mutual or cooperative banks)
 - ◆ *"The Agreement is entered into with a private commercial legal entity organized under French law (the "**French Counterparty**") which could be a credit establishment or investment firm, an insurance or reinsurance company or a SICAV, but other than those entities, such as real estate companies (sociétés de crédit foncier) that are subject to a special regime of insolvency"*
- Explanatory note
 - ◆ *"This memorandum does therefore not consider the insolvency of any entity having no legal personality, such as FCC, FCP or other funds or partnerships, nor any Agreement entered into with individuals, non commercial private entities, entities governed by public law, such as the Central Bank, La Poste, la Caisse des Dépôts et Consignations, IEDOM, IEOM, le Trésor Public, l'Agence de la Dette, the State itself, any local authorities, public establishments or [crédits municipaux]"*

IMPACTS ON ISDA OPINIONS

ENTITIES COVERED - ASSUMPTION

- *Scope rationae personae*
 - ◆ *"At least one of the parties to the Agreement (who does not need to be the French Party) has the status of a credit establishment, an investment services provider, a public establishment [établissement public], a territorial authority [collectivité territoriale], an institution, a person or an entity having the benefit of the provisions of Article L.531-2 [with the exception of persons listed in paragraphs 2(c) to 2(i) of such article], a clearing house, a non-resident establishment with a comparable status, an international financial organisation or body which France or the EU is a member of"*

ANNEX - IMPACTS ON ISDA OPINIONS

TRANSACTIONS COVERED

- Broader scope of transactions covered
 - ◆ All Annex A Transactions
 - ◆ Whether collateralized or not
 - ◆ ... provided that they are entered into between eligible counterparties
- New key Qualification on scope *rationae materiae*
 - ◆ "When only one party to the Agreement [is an eligible counterparty] all Transactions entered into between the parties and governed by the Agreement shall exclusively consist of "transactions on financial instruments" in the meaning of Article L.211-1 of the M&F Code."
 - ◆ Excluded transactions
 - Spot FX
 - Commodity spot
 - ◆ Specific developments for certain types of transactions
 - Credit and weather derivatives
 - Commodity derivatives (physical v/ cash settlement)
 - ◆ Risks of mixing "qualifying" and "non qualifying" transactions

ANNEX - IMPACTS ON ISDA OPINIONS

CONFLICT OF LAWS ISSUE

- Should people care at all about French law any more?
 - ◆ New EU conflict of laws rules
 - EU Directive no. 2001/24 of April 4, 2001 on the winding up of credit institutions
 - Differences between EU Regulation and Credit establishment winding up Directive approaches
 - ◆ Principle for credit establishments: application of the *lex concursus*
 - *i.e.* the law of the Member State where the credit institution has been authorised
 - In particular, to determine "*the conditions under which set-offs may be invoked*"
 - ◆ Exception (Art. 25)
 - "*Netting agreements shall be governed solely by the law of the contract which governs such agreements*"
 - ◆ Effect?
 - Disapplication of French law when the French party is a credit establishment?
 - Not entirely... French law applies to determine whether the Agreement is a "*netting agreement*"
 - ◆ Issues
 - General principles of laws v/ Special financial netting regime?

ANNEX - IMPACTS ON ISDA OPINIONS

CONFLICT OF LAWS ISSUE

- Treatment in the Opinion

- ◆ *"For the purpose of this opinion, we have assumed, when the winding-up of a French Counterparty is contemplated, that applicable French international conflict of laws rules, including those provided for by the Insolvency Regulation, designate French law as the applicable lex concursus. As regards French credit establishment covered by this opinion, we are of the opinion that a French court should consider, by application of the French law, that the Agreement qualifies as a "netting agreement" (convention de compensation et de novation) or a "repurchase agreement" (convention de mises en pension) in the meaning of (i) Articles 25 and 26 of Directive no. 2001/24/EC of April 4, 2001 on the reorganization and the winding-up of credit institutions and (ii) Article L.613.31-5 of the M&F Code"*

IMPACTS ON ISDA OPINIONS

NETTING OPINION SUMMARY CONCLUSIONS

- Enforceability under French law of the close-out provisions of the Master Agreements will not be impacted and will not depend upon the selection or not by the parties of Automatic Early Termination as the way to select the applicable Early Termination Date
- The Automatic Early Termination of the Master Agreements would be enforceable under French law in insolvency of the French company
- The close-out netting provisions of the Master Agreements would be enforceable under French law
- Such conclusions should not be altered by the fact that the French company is a Multibranch Party under the Master Agreements
- The inclusion of the 2001 ISDA Cross Agreement Bridge or the 2002 ISDA Energy Bridge in the Schedule to a Master Agreement would not materially affect our conclusions

ANNEX - THE FRENCH IMPLEMENTATION STEP BY STEP

TEXT OF ART. L.431-7 & *SEQ.*

ANNEX - THE FRENCH IMPLEMENTATION STEP BY STEP

GENERAL

- Most of the implementation has taken place through rewriting of Art. L.431-7
 - ◆ Former Art. L.431-7 has been abrogated
 - ◆ ... and replaced by 6 new Articles
 - L.431-7 *Scope - General provisions on close-out netting provisions - Protection against civil and commercial enforcement proceedings*
 - L.431-7-1 *Assignment of claims and contracts*
 - L.431-7-2 *Protection of close-out netting against insolvency*
 - L.431-7-3 *General provisions on fiduciary title transfers and security interests - Collateral perfection and enforcement simplified regime for inter-professional business - Protection against civil and commercial enforcement proceedings - Re-use*
 - L.431-7-4 *New conflict of laws rule*
 - L.431-7-5 *Protection of collateral against insolvency*

ANNEX - THE FRENCH IMPLEMENTATION STEP BY STEP

GENERAL

- Some amendments / adjustments have been made in some other Articles
 - ◆ Art. L.141-4 relating to the protection of collateral posted to national central banks and the ECB against civil and commercial enforcement proceedings
 - ◆ Art. L.330-1 and L.330-2 strengthening collateral posted in inter-banking payment systems and delivery versus payment systems
 - ◆ Abrogation of Art. L.311-4 relating to the close-out and collateral favorable regimes applicable to inter-banking deposits which is now integrated within Art. L.431-7
 - ◆ Clarification of certain provisions of Art. L.431-4 relating to French pledges
- Actual texts
 - ◆ Habilitation law no. 2004-1343 of December 9, 2004
 - ◆ Ordinance no.2005-171 of February 24, 2005
 - ◆ Ratifying Law no. 2005-842 of July 26, 2005

ANNEX - THE FRENCH IMPLEMENTATION STEP BY STEP

ART. L.431-7-I

I. *The provisions of this Section are applicable to:-*

1°) *Financial obligations resulting from transactions on financial instruments to the extent that at least one of the parties to the transaction is a credit establishment, an investment services provider, a public institution [établissement public], a local authority [collectivité territoriale], an institution, a person or an entity having the benefit of the provisions of Article L. 531-2, a clearing house, a non-resident establishment with a comparable status, an international financial organisation or body which France or the EU is a member of;*

■ Scope: the "mini opt-out"

- ◆ Art. L.431-7-I § 1°)
 - *"transactions on financial instruments"*
 - when at least one party is an eligible counterparty
 - The other one can be *e.g.* an ordinary corporate
- ◆ Keeping of the former favorable regime for dealings with ordinary corporate
- ◆ The Ordinance of February was providing further: *"provided that no party is a private individual"* - However, this has been deleted in the ratifying law of July

ANNEX - THE FRENCH IMPLEMENTATION STEP BY STEP

ART. L.431-7-I

2°) *Financial obligations resulting from any agreement giving right to a cash settlement and/or a delivery of financial instruments, to the extent that all parties belong to one of the categories listed in the paragraph above, with the exception of persons listed in paragraphs 2(c) to 2(i) of Article L. 531-2;*

3°) (...)

■ Scope: the "mini opt-out"

◆ Art. L.431-7-I § 2°)

- Any "*financial obligations*", in the meaning of the Directive
- Between eligible counterparties

◆ Exclusion however of certain types of eligible counterparties for that purpose, e.g.:-

- Corporate providing investment services within their group or on an ancillary basis
- Commodity dealers providing investment services to their clients only and in a manner ancillary to their main commercial activity
- Corporate having as principal activity the production, transformation, distribution or selling of commodities and negotiating derivatives in the normal framework of their activity

ANNEX - THE FRENCH IMPLEMENTATION STEP BY STEP

ART. L.431-7-II

*II. **Agreements** relating to the financial obligations referred to in I above may be early terminated, and the debts relating thereto may be netted among themselves. The parties may provide for the calculation of a single netted settlement amount, such financial obligations being governed either by **one or several agreements or master agreements**.*

-
- Deletion of any documentation related condition
 - ◆ Parties however must expressly provide and organize such netting
 - ◆ Close-out and global netting are now unified

ANNEX - THE FRENCH IMPLEMENTATION STEP BY STEP

ART. L.431-7-III

III. The termination, valuation and netting procedures of the transactions and obligations referred to in I and II are effective vis-à-vis third parties. These procedures may be provided for in agreements or master agreements. Any termination, valuation or netting effected on grounds of civil execution proceedings or the exercise of a right of opposition shall be deemed to have taken place prior to said proceedings or to that action.

-
- Protection against civil or commercial enforcement proceedings
 - ◆ A timing issue
 - ◆ Covers any situations where
 - A third party take possession of the counterparty's assets or the counterparty has a distress, execution, attachment, sequestration or other legal process levied, enforced or sued on or against its assets; **and**
 - This triggers an Event of Default under the Agreement

ANNEX - THE FRENCH IMPLEMENTATION STEP BY STEP

ART. L.431-7-1

The assignment of claims relating to the financial obligations referred to in I of Article L.431-7, is effective vis-à-vis third parties upon notice of the assignment to the debtor. The assignment of agreements relating to the financial transactions referred to in I of Article L. 431-7 is effective vis-à-vis third parties upon written agreement between the parties.

-
- Confirmation of the validity under French law of the assignment of contracts
 - ◆ Possibility to assign obligations, as opposed to rights only
 - ◆ A useful alternative tool to "novation"

ANNEX - THE FRENCH IMPLEMENTATION STEP BY STEP

ART. L.431-7-2

The provisions of Book VI of the Commercial Code, or those equivalent governing any amicable or judicial procedures opened outside France, shall not interfere with the application of the provisions of this Section.

-
- Neutralization of French or foreign insolvency laws

ANNEX - THE FRENCH IMPLEMENTATION STEP BY STEP

ART. L.431-7-3-I

*I. As a guarantee for the current or future financial obligations referred to in I of Article L. 431-7, the parties may provide for transfers of title **fully effective vis-à-vis third parties without further formalities**, of **instruments, securities, bills, receivables, agreements, or cash**, or the creation of security interests over such assets or rights, enforceable even in the event that a procedure provided for in the Book VI of the Commercial Code or any equivalent judiciary or amicable procedure under a foreign law, or a civil execution proceeding or the exercise of a right of opposition is conducted against one of the parties.*

Reciprocal debts relating to such guarantees and those relating to such obligations may then be netted in accordance with the provisions of II of Article L. 431-7.

- Confirmation of the two possible collateralization methods under French law
 - ◆ Fiduciary title transfers
 - ◆ Security interests / pledges
- Broad range of eligible protected collateral
- Protection of top-up collateral, independent amounts, over-collateralization
- No perfection requirements for fiduciary title transfers
- Enforcement by set-off possible

ANNEX - THE FRENCH IMPLEMENTATION STEP BY STEP

ART. L.431-7-3-II

II. *When the guarantees referred to in I above are relating to the financial obligations referred to in the second and third paragraphs of I of Article L. 431-7:-*

- 1°) *The creation and perfection of such guarantees shall not be conditional upon any formality. They arise from the transfer of the relevant assets and rights, of the collateral giver dispossession or of their control by the beneficiary or a person acting on its behalf;*
- 2°) *The evidence and transfer of the relevant assets and rights, or the collateral giver dispossession or the control by the beneficiary shall be certified in writing;*
- 3°) *The enforcement of such guarantees is conducted on an arms'-length basis at normal market conditions, by set off, appropriation or sale, without prior notice, in accordance with the valuation terms agreed upon by the parties, provided that the underlying financial obligations have become due.*

- Creation of a simplified regime for inter-professional collateralization
 - ◆ No perfection requirements for pledges
 - ◆ ... apart from a writing evidencing the dispossession
 - ◆ Private enforcement in accordance with "normal market conditions" possible

ANNEX - THE FRENCH IMPLEMENTATION STEP BY STEP

ART. L.431-7-3-III

III. The document providing for the constitution of the guarantees referred to in paragraph I above may define the terms upon which the beneficiary of such guarantees will have the right to use or dispose of the relevant assets or rights, provided for such beneficiary to return to the collateral giver equivalent assets and rights. The relevant guarantees relate to equivalent assets or rights returned as such as if they had been constituted from the beginning on such equivalent assets or rights. Such document may permit the beneficiary to set off its obligation to return equivalent assets and rights with the collateralized financial obligations which are due.

- Introduction of the re-use pledged collateral
 - ◆ A contractual right (not automatic)
 - ◆ Subject to the obligation to return "equivalent collateral" (cf. next slide)
- One of the last unresolved issue of the implementation
 - ◆ Fixing the accounting and tax regime
 - ◆ Concerns about extending the current tax neutrality regime

ANNEX - THE FRENCH IMPLEMENTATION STEP BY STEP

ART. L.431-7-3-III

Equivalent collateral shall mean:-

1°) In relation to cash, the same amount and in the same currency;

2°) In relation to financial instruments, financial instruments of the same issuer or debtor, forming part of the same issue or category and of the same nominal amount, currency and description or, other assets, when the parties so provide, following the occurrence of any event relating to or affecting any financial instruments provided as financial collateral;

3°) In relation to other assets or rights, such identical assets or rights.

- Definition taken directly from the Directive

ANNEX - THE FRENCH IMPLEMENTATION STEP BY STEP

ART. L.431-7-3-IV

IV. The enforcement and set-off procedures relating to the guarantees referred to in I and obligations referred to in I of Article L. 431-7 are effective vis-à-vis third parties. Any enforcement or set-off effected on grounds of civil execution proceedings or of the exercise of right of opposition shall be deemed to have taken place prior to said proceedings.

-
- Enforcement protected against
 - ◆ Civil or commercial enforcement proceedings
 - ◆ French or foreign insolvency laws

ANNEX - THE FRENCH IMPLEMENTATION STEP BY STEP

ART. L.431-7-4

*The rights or obligations of the guarantor of the beneficiary or of any third party, relating to the guarantees referred to in I of Article L. 431-7-3, evidenced by registered financial instruments are determined by **the law of the State in which the account on which the financial instruments are deposited or constituted as guarantee.***

-
- Clarification of *lex rei sitae* for book-entry securities
 - Common rules to most EU Member States
 - Likely changes to come with the Hague Convention, Unidroit...

ANNEX - THE FRENCH IMPLEMENTATION STEP BY STEP

ART. L.431-7-5

The provisions of Book VI of the Commercial Code, or those equivalent governing any amicable or judicial procedures opened outside France, shall not interfere with the application of this Section.

-
- Neutralization of French or foreign insolvency laws
 - ◆ Symmetric provisions to Art. L.431-7-3

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