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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

on the review of settlement finality in payment and securities settlement systems including its application to domestic institutions participating in third-country systems and of financial collateral arrangements under Directives 98/26/EC and 202/47/EC

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1. INTRODUCTION

The CMU is the EU's plan to create a truly single market for capital across the EU. Well-functioning payment systems such as TARGET2[1] and securities settlement systems such as central counterparties (CCPs) and central securities depositories (CSDs) ensure that payments and securities transactions can be made safely and with certainty and this is an important foundation for the financial sector and thus for the Capital Markets Union.

The Settlement Finality Directive (SFD)[2] aims to reduce systemic risk arising from the insolvency of participants in payment and securities settlement systems ('systems'). It was adopted in 1998 and has since been amended five times. The most recent amendment to the SFD, introduced via the second Bank Recovery and Resolution Directive (BRRD2)[3] in 2019, requires, under Article 12a of the SFD, the Commission to review how Member States apply the SFD to their domestic institutions[4] which participate directly in systems governed by the law of a third country (i.e. non-EU country) and to collateral security provided in connection with participation in such systems. In particular, the Commission was asked to assess the need for any further amendments to the SFD with regard to systems governed by the law of a third country ('third-country system').

Taking into account their mutual links, the review of both the SFD and the Financial Collateral Directive (FCD)[5] assessed the developments since the last review of the SFD, which took place in 2008/2009, and their potential impact on the business, technological and regulatory environment to ensure the SFD and FCD continue to function as intended.

To inform these reviews, a meeting with Member States was held on 27 October 2020 and targeted consultations on both Directives were launched[6] (the consultations).

This report recalls the objectives of the SFD and FCD. It explains how, and to what extent, Member States exercise the discretion to extend the protection under SFD to domestic institutions participating in third-country systems, as referred to in Recital 7 of

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([1]) TARGET2 is the real-time gross settlement system owned and operated by the Eurosystem.
([2]) Directive 98/26/EC (OJ L 166, 11.6.1998, p. 45).
([3]) Article 12a SFD, introduced via Directive (EU) 2019/879 (OJ L 150, 7.6.2019, p 296).
([4]) The definition of 'institution' in Article 2(b) SFD includes credit institution (domestic and third-country), investment firm (domestic and third-country), public authorities and publicly guaranteed undertakings.
([5]) Directive 2002/47/EC (OJ L 168, 27.6.2002, p. 43).
([6]) With a feedback period from 12 February to 7 May 2021; https://finance.ec.europa.eu/regulation-and-supervision/consultations/2021-settlement-finality-review_en and https://finance.ec.europa.eu/regulation-and-supervision/consultations/2021-review-directive-financial-collateral-arrangements_en

the SFD[7], and summarises the main areas that may warrant further reflection to ensure that the SFD and FCD continue to serve its intended purpose.

2. THE SETTLEMENT FINALITY DIRECTIVE (SFD)

Reduction of systemic risk requires the finality of settlement and the enforceability of collateral security. Hence, the SFD protects systems as well as participants thereof falling within the scope of the SFD by ensuring transfer orders and netting are legally enforceable under all Member States' jurisdictions and binding on third parties and that transfer orders cannot be revoked after a moment defined by the rules of the system. In other words, the SFD protects systems by disapplying certain national insolvency rules to ensure that payments and security transfer orders become final, even if the instructing party becomes insolvent.

The SFD applies to systems designated as such by a Member State[8] and participation in SFD-designated systems is mainly limited to banks, investment firms and system operators[9].

2.1. Application of SFD to systems governed by the law of a third country

The SFD does not apply to third-country systems, however, as referred to above, Member States are free to adopt legislation to extend the protections contained in the SFD to domestic institutions participating directly in third-country systems and to any relevant collateral security ('extension for third-county systems')[10].

Given the global size of and activities within some third-country systems and the increased participation of entities established in the EU in such systems[11], the review clause in Article 12a of the SFD tasked the Commission to assess *"how Member States apply this Directive to their domestic institutions which participate directly in systems governed by the law of a third country and to collateral security provided in connection with participation in such systems."*.

There are different practices on how to undertake an extension for third-county systems among the Member States.[12] By applying the SFD protections to such domestic participants the national law is disapplied for orders that are entered into the third-country system thereby contributing to the settlement finality of those orders.

13 Member States[13] indicated that they do not have in place a regime for an extension for third-county systems. Of those Member States:

- 5 explicitly indicated their preference for a harmonised approach at EU level;
- 3 stated that their national institutions had not asked for access to third-country systems;
- 2 noted that no further harmonisation was needed and 1 of them noted that third-country systems did not pose substantial risk for the financial stability of the EU.

([7]) Please see Recital 7 in the SFD as adopted in 1998 (https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31998L0026)

([8]) Article 2(a) of SFD.

([9]) For more details see Article 2(f) SFD and section 2.2. of this report.

([10]) Recital 7 states "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".

([11]) See Recital 34 of the BRRD2.

([12]) 23 Member States replied to the Commission survey, with the exception of the following four (EL, IE, LV, MT). The number of Member States quoted in the sections below are based on the 23 Member States who replied to the consultation.

([13]) AT, BG, CY, CZ, ES, HR, HU, LT, PT, SI, SK, RO, PL

10 Member States[14] have a regime in place for a possible extension for third-county systems and have implemented national legislation applying the provisions of the SFD to their domestic institutions that participate in third-country systems to ensure, in particular, EU banks are able to continue participating in third-country systems after the UK's departure from the EU. Of those Member States:

- 6[15] indicated they applied substantive provisions of the SFD in their entirety[16] in the event of insolvency proceedings against a participant in the third-country system (i.e. rights and obligations under or in connection with participation in a system are solely determined by the law governing that system);
- none of the Member States indicated that they apply the extension under the condition of reciprocity, i.e. they do not apply the extension only if the third country provides similar protections to its entities participating in SFD-designated systems.

7 Member States[17] with a regime in place for a possible extension for third-county systems assess a **third-country system's compliance on a case-by-case basis with certain criteria** and if they are satisfied that those criteria are met, the system is granted an extension for third-county systems [18] [19]. Of those Member States:

- 4[20] have only decided on an extension for third-county systems for domestic participants participating in UK-based systems;
- 1 has in place a regime for an extension for third-country systems but has not done an assessment for any system yet, as no specific request to do so was received;
- 2 [21] require that the system is based in a country whose central bank is a member of the Bank for International Settlements;
- 5 [22] consider the adequacy of the rules of the system and require a protection of the third-country law similar to the SFD. Of those Member States:
  - 2[23] indicated the need for an equivalence decision by the Commission and a recognition decision for the CCP by ESMA under Regulation (EU) No 648/2012[24] for the SFD protection to be extended for participants in third-country CCPs;
  - 2[25] highlighted that they applied the regime to systems that they considered of systemic importance;
  - 1 demands that the system operator is adequately supervised by an authority or other competent body, and that the system needs to be organised in such a way that the financial status of the participants in the system can be overseen;

(14) BE, DE, DK, EE, FI, FR, IT, LU, NL, SE
(15) BE, DE, FI, LU, NL, SE
(16) Excluding SFD provisions concerning EU specific procedures such as Article 6(3) and Article 10(1) SFD.
(17) DK, EE, FR, IT, LU, NL, SE
(18) Recital 7 states "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". In order to ensure easier readability, this report refers to 'Recital 7 designation' when a Member State exercises the discretion as referred to in Recital 7 of the SFD in national law.
(19) This decision is made publicly available afterwards in 5 Member States (DK, FR, IT, LU, SE).
(20) DK, FR, IT, SE
(21) LU, NL
(22) DK, EE, FR, IT, SE
(23) FR, IT
(24) Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (OJ L 201, 27.7.2012, p. 1).
(25) FR, SE

- 3[26] require the system operator to provide necessary information, including the rules of the system, the participants in the system and important changes to the third country's laws affecting the system;
- 1 requires system operators of third-country systems to provide a legal opinion certifying that the level of regulatory security is equivalent to that of systems governed by the law of that Member State.

3 Member States[27] with a regime in place for a possible extension for third-county systems **do not assess the compliance of a third-country system upfront.** Instead, only third-country systems that correspond to the definition of a system under the SFD can be subject to such extension and where this is the case, then in an insolvency proceeding of a domestic participant, the rules governing the third-country system apply to the domestic participant to such third-country system. Of those Member States, 1[28] indicated that it also assessed the equivalence of third-country systems, in connection with the insolvency proceedings of a domestic participant, and the law of the third-country would only become applicable where the third-country system is equivalent to the systems within the scope of the SFD.

Third-country systems have an interest in legal certainty and settlement finality protection in the case of the insolvency of their EU participants. Hence there is a risk that participants from Member States, that have not extended the SFD protections to such participation in third-country systems, might be refused access to third-country systems. Because not all Member States have extended the SFD protections to participants in third-country systems, and because those Member States that have done it apply different criteria and different procedures to grant the extension, there is a lack of a harmonised treatment of participation in those systems in the EU. This has an **impact on both, third-country systems and EU interests**.

2.2. Participants in SFD designated systems

Today, the SFD applies to a specific list of participants[29] (mainly EU banks, investment firms and operators of systems). For this reason, **payment institutions (PIs) and e-money institutions (EMIs)** have to rely on banks to get access to designated systems. The large majority of the respondents to the consultation were in favour of adding PIs and EMIs to the list of participants. Banks generally noted that those entities do not face as strict prudential requirements as banks, and as such their direct participation could pose risks that should be addressed by specific requirements to protect the system and its participants. PIs and EMIs ask to be allowed to be direct participants, claiming to incur additional costs for indirect access and pointing to the need to create a level playing field with banks. As part of the review of the PSD2[30] the Commission is proposing to extend the scope of the SFD to include PIs and EMIs. In addition, the Commission also notes the support for adding CSDs to the SFD list of eligible direct participants where they

(26) SE, EE, FR
(27) BE, DE, FI
(28) FI
(29) See Article 2(f) SFD for the definition of 'participant'. Participants include 'institutions' ('credit institutions' or 'investment firms' headquartered in or outside the EU, public authorities and publicly guaranteed undertakings, and any other undertaking participating in a national securities settlement system as determined by a Member State on the grounds of systemic risk (the latter discretion does not extend to payment systems)), 'CCPs', 'settlement agents', 'clearing houses', clearing members of an EMIR authorised CCP and 'system operators'.
(30) Proposal for a Directive of the European Parliament and of the Council on payment services and electronic money services in the Internal Market amending Directive 98/26/EC, and repealing Directives 2015/2366/EU and 2009/110/EC

participate in a system in the function other than that of 'settlement agent' or 'system operator' to provide clarity and transparency.

2.3. Systems based on Distributed Ledger Technology (DLT)

The SFD is intended to be **technologically neutral.** Current SFD concepts seem to work for centralised/permissioned DLT[31] systems. However, such concepts seem not to work for permission-less DLT[32] systems as there is no centralised operator, unidentified participants can enrol without restriction and functions can be attributed simultaneously to several participants.

With regards to centralised/permissioned DLT systems where current SFD concepts seem to work, targeted adaptations might potentially provide further clarity on how certain concepts apply, e.g. on the definition of 'transfer order'[33] and the concept of 'book-entry', as well as the definitions of 'settlement account'[34] and 'settlement agent'[35]. However, as the Regulation for a pilot regime on DLT market infrastructures (EU DLT Pilot Regime[36]) was only recently adopted, there is not yet enough experience on the benefits and risks associated with the use of DLT in trading and settlement[37]. Hence, any considerations on potential amendments to the SFD would be premature. The results of the EU DLT Pilot Regime can be expected to provide further insights to help with such considerations.

2.4. Additional aspects identified

The consultation, identified some issues for consideration, including the need for a requirement in the SFD that also a system operator should be immediately **notified about the insolvency** of a participant (in addition to an authority chosen by the Member State, the ESRB, ESMA and other Member States[38]) to bring legal certainty to the practises of sharing such information to the system. Another important question, which raised opposing views by the respondents to the consultation, was whether settlement **finality moments** should remain specified by the system operator in the rules of the system, as currently provided for by the SFD, or if such moments should be specified in the SFD to increase legal certainty for market participants.

([31]) A network in which only those parties that meet certain requirements are entitled to participate to the validation and consensus process (see footnote 4, Call for evidence, DLT Pilot Regime and review of MiFIR regulatory technical standards on transparency and reporting, 4 January 2022, ESMA70-156-4957).

([32]) A network in which virtually anyone can become a participant in the validation and consensus process (see footnote 3, Call for evidence, DLT Pilot Regime and review of MiFIR regulatory technical standards on transparency and reporting, 4 January 2022, ESMA70-156-4957).

([33]) Article 2 point (i) of the SFD.

([34]) Article 2 point (l) of the SFD.

([35]) Article 2 point (d) of the SFD.

([36]) Regulation (EU) 2022/858 (OJ L 151, 2.6.2022, p. 1).

([37]) Article 6 of the EU DLT Pilot Regime. In relation to DLT SS (Article 5 of the EU DLT Pilot Regime), there is for example an exemption for CSDs operating a DLT SS in the sense that the term 'participant' in the SFD is deemed to include, under certain conditions, persons other than those referred to in that Directive where such DLT SS ensure that the persons to be admitted as participants fulfil certain conditions. In addition, the EU DLT Pilot Regime allows a CSD to operate a DLT SS that does not qualify as a securities settlement system designated under the SFD, and an exemption from the rules on settlement finality in the CSDR is available, subject to certain compensatory measures, including to mitigate risks arising from insolvency, as insolvency protection measures under the SFD do not apply. However, such an exemption would not preclude a DLT SS, which complies with all the requirements of the SFD, from being designated and notified as a securities settlement system in accordance with that Directive. In addition, the EU DLT Pilot Regime contains similar exemptions where an investment firm or market operator operates a DLT TSS.

([38]) Article 6 of the SFD.

3. THE FINANCIAL COLLATERAL DIRECTIVE (FCD)

The smooth and safe exchange of collateral is essential for the well-functioning and stability of financial markets and the Capital Markets Union. The FCD was adopted on 6 June 2002 and introduced a harmonised framework for the use of financial collateral to secure transactions and it contributed to enhancing cross-border use of financial collateral. Such a more comprehensive approach, covering over-the-counter (OTC) transactions, was deemed necessary because of divergent national rules applicable to financial collateral were frequently impractical and often opaque.

The FCD does not aim to fully harmonise national laws applicable to financial collateral arrangements. Rather, it aims to remove barriers to the timely cross-border creation and operation of such collateral arrangements. This aim is achieved by providing protection to collateral takers notably by: (i) ensuring that financial collateral arrangements can be mobilised and are usable without delay due to national formalities; (ii) ensuring close-out netting[39] provisions are enforceable in accordance with their terms and (iii) ring-fencing the operation of financial collateral arrangements should one of the parties become insolvent.

While these protections constitute exceptions to the principles of equal treatment of creditors upon the opening of insolvency proceedings and universality of insolvency proceedings they are needed to help to avoid systemic contagion risks throughout the EU.

3.1. Who should benefit from FCD protection?

To benefit from the FCD's protections, the collateral taker and the collateral provider, must be one of the entities listed in Article 1(2) of the FCD[40]. Respondents noted that the FCD should cover all systemically important market participants. While CSDs were generally considered as systemically important, the views differed to greater extent on PIs and EMIs. Consequently, to extend the scope of the FCD to additional market participants such as PIs and EMIs warrants further consideration and monitoring, in particular in relation to the level of supervision and the need to align FCD and SFD considering the proposed changes under PSD II to include PIs and EMIs under the SFD.

3.2. Which types of financial collateral should benefit from FCD protections?

Currently, cash, financial instruments and credit claims are eligible as financial collateral under the FCD[41]. To keep up with market and regulatory developments affecting financial collateral that is currently used, or may be used in future by market participants, the current list of eligible financial collateral under the FCD could be reviewed, for example, to consider whether to include, if the scope of financial collateral would be considered to be extended, bank guarantees, emission allowances, commodities and commodities instruments. Any such extension would have to meet the requirements under FCD, including key concepts such as 'possession' and 'control' of the financial collateral to ensure, for example, that the collateral provider is prevented from disposing of the collateral.

([39]) Close-out netting is an arrangement commonly used in financial markets, to set off and replace all agreed but not yet due liabilities and claims vis-à-vis a counterparty by one single claim/liability. It ordinarily covers instances where a counterparty defaults or becomes insolvent.

([40]) The list covers public authorities, central banks, financial institutions (such as credit institutions and investment firms), CCPs, settlement agents and clearing houses. A person other than a natural person (including unincorporated firms and partnerships) can also be within the FCD's personal scope, provided that the other party to the financial collateral arrangement is one of the aforementioned entities.

([41]) Article 1(4), point (a) of the FCD.

The FCD is intended to be **technologically neutral**. Accordingly, it can apply to DLT based collateral if the latter complies with the conditions set out in that Directive. However, for crypto-assets to qualify as financial instruments, the ownership provision, possession and control requirements of the FCD, might potentially raise issues[42]. Questions remain how these issues could be addressed and whether the FCD would be the right place to do so. The results of the EU DLT Pilot Regime might provide further insights on this issue.

3.3. Additional aspects identified

It was noted in the consultation that the diverging implementation of the FCD by Member States, especially concerning the scope and opt-out provisions[43], have resulted in legal uncertainties and risks for market participants, in particular in the context of netting arrangements. Some respondents claimed in particular that there were legal issues related to the application of national avoidance actions affecting **close-out netting provisions** that might lead to challenges in the application of such provisions. There were also suggestions to improve the coherence of EU legislation on netting and to expand the material scope beyond the collateral arrangements. As the FCD deals primarily with financial collateral and only peripherally with netting (only as one of the methods that can be used to enforce collateral arrangements), the Commission remains[44] of the view that an amendment of the FCD is likely not the right place to improve the general EU framework for netting.

Furthermore, industry respondents asked for a clarification and high-level guidance regarding the **FCD concepts of 'possession' and 'control'** noting that whilst those aspects have been subject to a judgement of the Court of Justice of the European Union[45] it remains appropriate for detailed guidance to be provided at a national level, as each jurisdiction has its own laws on security and insolvency procedures. Other respondents considered that further high-level guidance could be usefully provided at the EU level.

4. CONCLUSIONS

In general, both Directives have worked well and no major overhaul of the SFD and the FCD seems warranted for the time being. Still, stakeholders have raised issues that could warrant further investigation and monitoring. For one of the aspects raised, namely extending the scope of the SFD to PIs and EMIs, the Commission decided to propose an amendment as part of the review of the PSD2[46].

Overall, the Commission notes the possible impacts of new technology as well as the lack of legal certainty in certain areas conducive to potential additional costs for the

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([42]) For example, dispossession and control can be challenging in the context of DLT as, in many models, what might constitute legal ownership in a DLT may be unclear. This is primarily a matter for national securities, corporate, contract and/or property law. Furthermore, enforcement of rights might rely on the actions of others (e.g. where private keys from different parties are needed to transfer an instrument and/or validation of transfer requires consensus from different nodes).

([43]) For example, a Member States can, pursuant to Article 1(3) of the FCD, opt to disapply, i.e. can exclude situations from the scope of the FCD financial collateral arrangements where one of the parties is a person, including unincorporated firms and partnerships (Article 1(2), point (e) of the FCD).

([44]) Commission Report 'Evaluation report on the Settlement Finality Directive 98/26/EC', COM (2005) 657 final/2.

([45]) Court of Justice of the European Union; case C-156/15 of 10 November 2016; where the Court specified that "the taker of collateral (...) may be regarded as having acquired 'possession or control' of the monies only if the collateral provider is prevented from disposing of them ".

([46]) Proposal for a Directive of the European Parliament and of the Council on payment services and electronic money services in the Internal Market amending Directive 98/26/EC, and repealing Directives 2015/2366/EU and 2009/110/EC.

financial market participants. It is noted that a lower level of harmonisation leaves a considerable discretion for transposition and implementation to Member States and may create difficulties in cross-border situations, some of which have also been identified in this review. However, any further harmonisation of SFD and FCD provisions should carefully consider the costs and benefits.