FINANCIAL COLLATERAL: COMPATIBILITY OF THE ‘FINANCIAL COLLATERAL DIRECTIVE’ (FCD) AND CHAPTER V OF THE ‘GENEVA SECURITIES CONVENTION’ (GSC)

LLM THESIS
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I am honored and grateful to Professor T. Keijser for giving me the chance to write a Dissertation on a topic of great interest to me, for his guidance and his support during the writing of this thesis.

He is an inspiration for me.

I am also honored and grateful to Professor A. Kaisis for providing us, through this innovative LLM, the opportunity to come into contact with new legal areas and with great Professors, as well as for his support in the difficulties we faced as LLM students.

I am always happy and thankful to my family and to the people close to me, for everything.
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I. INTRODUCTION

INT-1. In the latest decades, financial markets experienced the dematerialization of securities and the globalization of financial services. Nowadays, financial investments take place in an international level with cross-border securities book entries. In other words, securities holdings take place across multiple jurisdictions.¹

INT-2. However, the legal consequences of the securities holdings vary in every jurisdiction involved, creating legal uncertainty to the participants in securities transactions,² due to the possible absence of specialized provisions -on transactions with securities- in some national legal orders or due to the incompatibility between the national rules of each State.³ This situation may lead to significant losses in the relevant market participants. In other words, they bear legal risk.⁴

INT-3. The avoidance of legal risk is of particular importance to the creditors who acquire cross-border held securities or interests in them, as collateral security, in lieu of financial collateral agreements.⁵ The collateral takers are particularly sensitive to legal risk, since there are sometimes different national legal doctrines as to the nature of collateral (security/pledge), its transfer and the rights deriving from it, which are incompatible one to another.

INT-4. To combat the legal risk and to facilitate the conduct of international financial investments, the European Commission and UNIDROIT undertook the initiative to draft the ‘Financial Collateral Directive’ and the ‘Geneva Securities Convention on Substantive Rules for Intermediated Securities’, respectively. Both pay substantial attention to financial collateral agreements, as it is obvious from the fact that the latter constitute the sole object of the whole ‘Financial Collateral Directive’⁶ and of Chapter V of the ‘Geneva Securities Convention on Substantive Rules for Intermediated Securities’⁷.

INT-5. With their provisions, the ‘Financial Collateral Directive’ and Chapter V of the ‘Geneva Securities Convention on Substantive Rules for Intermediated Securities’, both intend to achieve compatibility of legal systems,⁸ in order to limit the legal and systemic risk arising from cross-border financial collateral transactions.⁹ They establish common legal frameworks on the ‘law of collateral’,¹⁰ which may also constitute new law for the Member or Contracting States not having yet adopted such legislation¹¹.

² Gullifer-Ownehship, at p.p.4-5.
³ Gullifer-Ownehship, at p.p.4-5.
⁵ Thevenoz, at p.p.392.
⁷ UNIDROIT Convention on Substantive Rules for Intermediated Securities, CONF. 11/2, Doc. 42 [hereinafter GSC].
⁹ Recital (3) of the GSC Preamble, GSC Official Commentary, par. Int-16 and Int-21.
¹⁰ Recitals (1), (3) and (22) of the FCD Preamble and Recital (5) of the GSC Preamble.
II. COMPATIBILITY OF THE EU FINANCIAL COLLATERAL DIRECTIVE AND CHAPTER V OF THE GENEVA SECURITIES CONVENTION

In this Dissertation Thesis, the Financial Collateral Directive (hereinafter Collateral Directive), will be compared with the provisions of the fifth (V) Chapter of the Geneva Securities Convention (hereinafter Geneva Convention) on Financial Collateral Transactions, aiming at detecting if those legal instruments are compatible.

Before proceeding with the substantive topics, it is considered appropriate for a systematic review, to present, first, the legal nature and the basic principles, which are instilled into the entire body of the Collateral Directive and Geneva Convention.

The comparison of the aforementioned instruments, as regards the legal issues, will follow the following structure: the Collateral Directive is the anchor of the analysis and the Geneva Convention is analyzed and contradicted in parallel. This structure is used not only to avoid repetitions, but also to emphasize on the topics, where the similarities and differences of these legal instruments are found.
A. LEGAL NATURE AND BASIC PRINCIPLES

A.1. Both the Collateral Directive and the Geneva Convention are legal instruments regulating a supra-national legal order.

In particular, the Collateral Directive belongs to the *aquis communautaire* of the European Union (EU), a *sui generis* supra-national legal system with its own competences.\(^{12}\) The latter are conferred to the EU\(^{13}\) by the Member States\(^{14}\) and should be exercised according to the principles of subsidiarity and proportionality,\(^{15}\) reflected\(^{16}\) in the text of the Collateral Directive. As regards its legal nature, the Collateral Directive is a legal act of a European Institution, ‘binding, as to the result to be achieved, upon each Member State’ (Article 249 of the Treaty of the Functioning of the European Union). Therefore, the Member States are obliged to incorporate and adapt the Collateral Directive to the domestic legal regime.

A.2. On the other hand, the Geneva Convention was drafted as a binding international law instrument by the International Institute for the Unification of Private Law (UNIDROIT)\(^{17}\) to be adopted as a Convention by the representatives of UNIDROIT Member States.\(^{18}\) In contrast to the Collateral Directive, the Geneva Convention was designed and adopted, so as to apply, only if the States sign the Geneva Convention and fulfill other constitutional requirements of their domestic law, such as ratification, accession etc.\(^{19}\) Thus, the application of the Geneva Convention is optional for the Contracting States.

A.3. It should be highlighted that not only the whole Geneva Convention is optional, but also its Chapter V, which includes rules on the financial collateral arrangements. Chapter V was given optional character, so that the Geneva Convention could address more Contracting States, by responding to their public policy issues, especially of consumer protection and insolvency.\(^{20}\)

A.4. As to the principles, the drafters of the Geneva Convention adopted: the minimalist approach, the functional approach and the compatibility with other relevant instruments. The minimalist approach works in an equivalent way with the principles proportionality and subsidiarity of the Collateral Directive, in the sense that the Geneva Convention regulates only those issues necessary to achieve the purpose of the Convention.\(^{21}\) The functional (and neutral) approach\(^{22}\) of the Geneva Convention

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13. It was drafted by the European Commission and adopted by the European Parliament and the Council of the European Union according to the procedure of Article 251 TEC, now Article 294 TFEU.


15. Article 5(b) and (c) of the Treaty establishing the European Community (TEC), now Article 5 (3) and (4) of the Treaty of the Functioning of the European Union (TFEU) and *Borchardt*, p.p. 41.

16. It covers only those issues, which the States cannot regulate on their own, due to reasons of scale and effects of the action (principle of subsidiarity), and only to the minimum extent possible (principle of proportionality- *Recital (22)* of the FCD).


22. *Recital (6)* of the GSC Preamble.
represents the use of legal terms which introduce rules, whose content is formulated by reference to their results, so that these legal terms are as neutral\(^23\) as possible.\(^24\) The Collateral Directive does not refer to any such principle, as the functional approach, since the full range European Law is interpreted autonomously by the European Court of Justice.\(^25\)

### A.5

As to the holding systems which are addressed by the Collateral Directive and the Geneva Convention, it appears that the Collateral Directive addresses mostly non-intermediated systems\(^26\), whereas the Geneva Convention is drafted on the structure of intermediated systems\(^27\). The Collateral Directive applies to securities as collaterals, which can be directly and indirectly held by the investors.\(^28\) There is no relevant provision as to the types of holding systems, to which it applies, and the Preamble is also not very helpful to this direction. However, the conclusion that the Collateral Directive covers all possible holding systems arises out of the absence of terms referring to intermediation in the text of the Collateral Directive and out of the fact that there is great variety of holding system types among the Member States. Indicatively, there are transparent systems\(^29\), trusts systems\(^30\), systems of full undivided property interests\(^31\), systems of pooled holding\(^32\). What is more, in Europe, intermediaries mostly function as brokers of the investors and not as persons legally responsible with their own, independent role as to the fulfilment of legal obligations against the investors.\(^33\)

### A.6

On the other hand, the Geneva Convention presupposes that every Contracting State has some kind of intermediated holding system.\(^34\) Moreover, all of its rules are adapted to an ‘intermediated system’ (‘intermediated securities’, ‘credit-debit’, ‘control agreement’, ‘insolvency of an intermediary’). In other words, the Geneva Convention does not apply when the securities are directly held by the investor or they are registered with their issuer in the name of the investor.\(^35\) For the systems, where the intermediaries are not legally responsible for the holding of securities against the investors, the Convention addresses other persons as conducting the functions of intermediaries.\(^36\) These other holding patterns, such as the ‘transparent systems’, are addressed only when the securities account agreement is concluded as a brokerage contract and not as the necessary legal act in order to invest in securities.\(^37\)

### A.7

As to the determination of the subject, the Collateral Directive regulates only financial collateral arrangements, while the Geneva Convention covers all the issues arising during the function of an

\(^23\) In particular, the functional approach does not attempt to equate either the relevant national doctrines, eliminating the underlying legal traditions of each State, or the results arising from the application of these doctrines - in particular in the field of proprietary and insolvency law.-


\(^25\) Borchardi, at p.p. 115.

\(^26\) ‘Non-intermediated’, with the meaning of not institutionally and functionally necessary intermediaries.

\(^27\) Chun, p.p 33 and UNIDROIT Study LXXVIII. DOC 19, at 1.2.1 [hereinafter DOC 19].


\(^29\) Nordic Countries, Greece, Spain.

\(^30\) England and Wales.

\(^31\) France.

\(^32\) Germany and Austria.

\(^33\) Similarly, in GSC Official Commentary, par.1-43.

\(^34\) GSC Official Commentary, par.29-14.

\(^35\) GSC Official Commentary, par. 1-19.

\(^36\) GSC Official Commentary, par.7-1.

intermediated system, from the creation of the rights in intermediated securities, their acquisition and the conclusion of collateral arrangements in intermediated securities to the insolvency of the intermediary. Thus, the Geneva Convention has a wider object than the Collateral Directive.
B. PERSONAL SCOPE

i) The Financial Collateral Directive

B.1. The Collateral Directive applies to bilateral financial collateral arrangements, and the categories to which the two parties in the arrangement may belong are determined in Article 1(2). The latter provides that there are two options for the Member States, to determine the entities to which the Collateral Directive applies:

1. According to the first, both parties should belong to the following categories: (a) public authorities, including the public sector bodies participating in the administration of public debt or authorized to hold accounts for customers, (b) National Central Banks (NCB), the European Central Bank (ECB), the Bank for International Settlements (BIS), Multilateral Development Banks (MDB), the International Monetary Fund (IMF) and the European Investment Bank (EIB), (c) financial institutions subject to prudential supervision, including credit institutions, investment firms, financial institutions, insurance undertakings, undertakings for collective investment in transferrable securities (UCITS) and management companies, as well as (d) Central Counterparties (CCP), Settlement Agents or Clearing Houses, including similar institutions acting in futures, options and derivatives markets, and non-natural persons acting in a trust or representative capacity for other persons, including bondholders or holders of other forms of securitized debt or any aforementioned (from (a) to (d)) institution.

2. According to the second option, if one of the parties to the financial collateral arrangement is an institution or a person belonging to the aforementioned categories (under option 1), then the other party to the arrangement can be any other non-natural person, including unincorporated firms and partnerships. In other words, this option excludes individual entrepreneurs, but includes foundations and all kinds of associations, even without legal personality.

B.2. It is clear from both options that the Collateral Directive does not apply to financial collateral arrangements in two cases: first, when a party is a natural person, and second, where both parties belong to the category of Article 1(2)(e), such as partnerships, associations, unincorporated firms and
foundations. The requirement that one of the parties to the collateral agreement should be an entity included in Article 1(2)(a),(b),(c),(d), is due to the intention of the European Commission to impose the application of the Collateral Directive in regulated transactions. This is the case under the Collateral Directive, because the entities of Article 1(2)(a),(b),(c),(d) are considered as regulated.

B.3. The participation of micro, small and medium enterprises in a financial collateral arrangement, having as counterparty a major market participant, is covered by both of the aforementioned options. In the first option, the category of ‘non-natural persons acting in a trust or representative capacity for other persons’ can include also minor market participants along with the major ones. However, it is the second option that addresses, in practice, mostly micro, small and medium enterprises, widening the scope of application of the Collateral Directive. This wide personal scope of application was introduced to facilitate the access of no or low credit rating businesses to easy and low-cost credit, and was supported by representatives of the banking and financial derivatives industry, in their pursuit of achieving a wider customer range.

B.4. However, due to accusations of overriding fundamental national insolvency principles for the equality of creditors (paritas creditorum), as well as to concerns of lack of fair balance or bargaining power (Verhandlungsmacht) between the parties to the financial collateral arrangements, the European legislator kept a neutral position and left the choice between the efficiency of financial markets and the ‘rule of law’ to the national authorities to decide if they would implement the wider personal scope or not.

B.5. In particular, the Collateral Directive provides the Member States with the opt-out possibility to exclude the aforementioned second option. The opt-out clause limits the personal scope of application, by allowing Member States to ‘exclude from the scope of this Directive financial collateral arrangements where one of the parties is a person mentioned in paragraph 2(e)’—i.e. non-natural person, including unincorporated firms and partnerships—(Article 1(3)).

ii) Chapter V of Geneva Securities Convention

50 It goes without saying that public authorities, systemic banks and central counterparties are regulated and for the rest entities it is stated: “financial institution subject to prudential supervision” (Article 1(2)(c)).
54 In particular, that the new regime would result in the creation of special privileges for banking and financial institutions detrimental to the other creditors of SMEs, providing the former with unlimited access to companies’ assets in insolvency situations, See T.R.M.P.Keijser, p.p. 52 and Klaus M. Loeber, ‘The German Implementation of the EC Directive on Financial Collateral Arrangements’, Journal of International Banking Law and Regulation, 2005, p.p. 73 [hereinafter Loeber-German Implementation].
56 Risk, which was not eliminated in total with the introduction of the provision of article 1(4)(c), with the Amending Directive Article 2(4)(and will be explained later), because the introduced exclusion covers only the consumers and leaves the commercial enterprises with low bargaining power inside the scope of the Directive 2002/47/EC.
57 Klaus Loeber and Ewa Klima, p.p.207.
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B.6. Chapter V of the Geneva Convention applies only to the parties of a collateral agreement, the collateral provider and the collateral taker,58 in other words it applies to bilateral collateral agreements.59

B.7. While it determines the terms ‘collateral provider’ and ‘collateral taker’, as the person granting an interest under a collateral agreement and the person being granted an interest in intermediated securities,60 respectively, the Geneva Convention has no particular article referring in the positive way to the identity of collateral providers and takers, namely it does not include any enumeration or categorization of the eligible persons. Thus, it appears that the Geneva Convention applies not only to all professional entities and legal persons, such as banks, pension funds, insurance undertakings, as well as small and medium enterprises and collective entities without legal personality, but also to natural persons.61 The same conclusion could be deducted also for the character of the eligible entities as regulated or non-regulated, as form the absence of any provision regarding this division, it seems that the Geneva Convention applies both to regulated and non-regulated entities. This wide circle of qualified persons can be explained by the pursuit of unlimited circulation of collateral and immediate satisfaction of creditors, without traditional procedural safeguards, with final purpose to achieve more liquidity in the market.62

B.8. However, the wider the personal scope, the more possible it is that unbalanced and unconscionable collateral arrangements may be concluded. Therefore, in order to avoid the imbalance of bargaining power between the parties to the collateral transaction, the drafters of the Geneva Convention added an opt-out clause under Article 38(2)(a), to provide the possibility of restricting the personal scope of Chapter V, for reasons of consumer protection and insolvency law63.64 By this opt-out provision, the Contracting States are given the opportunity to declare that the Geneva Convention will not apply inside their territory, having two options of declaration:

a) According to the first, they may exclude natural persons from the personal scope of the Convention, or

b) According to the second, they may specify in their declaration the categories of persons, which they would like not to be subject to the effects of the provisions of Chapter V.

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B.9. From a systemic point of view, while the Collateral Directive determines its personal scope in a positive way, by enumerating the market participants to be affected by it, the Geneva Convention follows the opposite route, including no provision to clarify its target group in the positive way. Instead, it draws the boundaries of its personal scope in a negative way, by providing opt-outs. Both instruments, though, end up without having definite frame of their personal scope, since the Member States are responsible for implementing, or not, the opt-out clauses and which of them.

58 Article 31(1) GSC.
59 Chun, p.p. 100.
60 Article 31(3)(f) and (g) GSC.
61 GSC Official Commentary, par. 31-27.
63 Chun, p.p. 100.
64 GSC Official Commentary, par. 38-9.
B.10. As to the teleological interpretation of the two instruments, both have the same *ratio* behind the opt-out clauses, namely the avoidance of inequality between parties to collateral arrangements and insolvency considerations.

B.11. However, the content of the opt-out clause is different in each case. The Collateral Directive excludes *a priori* all natural persons\(^6^5\) and does not allow the Member States exclude or include them. On the other hand, the Geneva Convention does not consider as self-evident the non-participation of natural persons in financial collateral arrangements and, thus, it leaves the exclusion of natural persons to the discretion of the Contracting States (Article 38(2)(a)). As a consequence, if a Member State of the European Union was to sign and incorporate the Geneva Convention, it would be obliged to make the declaration of the first option of Article 38(2)(a) of the Geneva Convention to avoid incompatibility.

B.12. As to the exclusion of legal persons, the Collateral Directive provides the Member States with the possibility to not incorporate the option, where one party to a collateral arrangement is any non-natural person, except a public authority, bank, financial institution, central counterparty, settlement agent or proxy of bondholders to the aforementioned institutions (entities referred under Article 1(2)(a),(b),(c),(d)). In other words, if the Member State adopts Article 1(3), it is obliged to restrict the personal scope of the Collateral Directive to the entities of Article 1(2)(a) to (d), public, authorities, banks, financial institutions, CCPS et.c, excluding all other legal persons, associations, foundations, unincorporated firms et.c, namely it has no power to alter the content of the opt-out clause. On the contrary, the Geneva Convention allows more freedom to its Contracting Parties as to the second option of Article 38(2)(a). In particular, the State is responsible to declare which categories of persons it would prefer to disqualify, without any direction being given by the Geneva Convention. Despite the different content of the opt-out clauses, both require from the Member States to adopt the opt-out clauses in their whole and not modify them or apply them partially.

B.13. Finally, a further divergence between the two legal instruments is that the Collateral Directive applies only to regulated entities, as it can be drawn from the categories of entities it has selected to include and the respective interpretation, while the Geneva Convention appears to cover also unregulated persons, since the absence of any prerequisite for the identity of the collateral providers and collateral takers cannot leave space for the opposite interpretation.

\(^6^5\) Article 1(2)(d) and (e) FCD, “...a person other than a natural person...”.
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C. MATERIAL SCOPE- TYPES OF COLLATERAL

i) The Financial Collateral Directive

C.1. Article 1(4) of the Collateral Directive determines the assets which can constitute financial collateral. In particular, the financial collateral can consist of financial instruments, cash and credit claims (Article 1(4)(a)). As financial instruments are considered shares in companies, securities equivalent to shares, bonds, other debt instruments\(^66\), if all these are negotiable on the capital market, and any other securities dealt in the market, which are used to acquire shares, bonds, other securities or to give rise to cash settlement, excluding instruments of payment, but including units in collective investment undertakings, money market instruments and claims for the aforementioned (Article 2(1)(e)). Cash refers to money credited to accounts, or claims for the repayment of money (Article 2(1)(d)), while credit claims means the pecuniary claims of a credit institution in lieu of a credit given by it in the form of loan (Article 2(1)(o)).

C.2. The material scope, though, can also be restricted. To this end, the Collateral Directive contains two opt-out provisions:

a) Article 1(4)(b) enables the exclusion of collateral provider’s own shares, shares in affiliated undertakings and in undertakings with exclusive purpose the ownership of essential to the collateral provider’s business means of production or the ownership of real property. In other words, it is possible to exclude the securities issued by the collateral provider himself, or by enterprises whose existence depends on the economic well-being of the collateral provider. The purpose of this opt-out clause is to avoid the use of collaterals, the value of which is closely linked to the financial situation of the collateral provider, because if the collateral provider runs financial difficulties, the collaterals issued by him may not qualify for recovery, since their value will decrease substantially, due to the financial turbulences in the collateral provider’s enterprise.\(^67\)

b) The second opt-out clause introduces the exclusion of credit claims from the list of eligible collaterals, on the basis of consumer protection concerns. In particular, the exclusion of credit claims is possible, when the debtor is a consumer or a micro or small enterprise (Article 1(4)(c)), where ‘consumer’ represents a natural person who is acting for purposes which are outside his trade, business or profession,\(^68\) a ‘small enterprise’ an enterprise which employs fewer than 50 persons and whose annual turnover total does not exceed EUR 10 million,\(^69\) and a ‘microenterprise’ an enterprise which employs fewer than 10 persons and whose annual turnover does not exceed EUR 2 million.\(^70\)

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\(^70\) Ibid.
C.3. There is also an exception to the ‘consumer’ opt-out in Article 1(4)(c) in fine. This states that the identity of consumer or micro-small enterprise is not important, whenever one of the parties to the collateral arrangement, the collateral provider or collateral taker, is an institution of Article 1(2)(b) of the Collateral Directive, namely a central bank, the European Central Bank (ECB), the Bank of International Settlements (BIS), multilateral development banks, the European Investment Bank or the International Monetary Fund (IMF). Therefore, exclusion of credit claims deriving from consumers or small enterprises is not possible, when the collateral arrangement involves a systemic major market participant—the avoidance of systemic risk supersedes the protection of consumers.

C.4. It should be highlighted, in order to avoid confusion, that under this opt-out provision, the consumer or the micro-small enterprises have the role of debtors in a loan agreement with credit institutions and not the role of collateral provider or collateral taker. The pecuniary claims arising from this loan agreement, are used as financial collateral in another agreement, the financial collateral agreement, which is the object of the Collateral Directive. Therefore, the identity of consumer or micro-small enterprise, does not refer to the personal scope of the Collateral Directive, but to the origin of the financial collateral, namely the material scope of the Collateral Directive. The relationship of this provision with the personal scope of the Collateral Directive is restricted to the impact, which is caused by the identity of an entity of Article (1)(2)(b), on the width of the material scope.

C.5. Another limitation to the material scope of the Collateral Directive is that the latter does not apply to collaterals, which have not yet been provided (Article 1(5) first sentence), namely when the collateral has not entered the sphere of financial domination of the collateral taker. As provision the Collateral Directive considers the delivery, transfer, holding, register or other designation, which result in the possession or control of the collateral taker on the collateral (Article 2(2)), where ‘control’ can be interpreted as representing the “practical equivalent of possession in the context of physical securities”.

In other words, collaterals still under the influence of the collateral provider are not eligible. The requirement of dispossession aims at ensuring that the provisions of the arrangement respond to its real performance and no risk of fraud exists, so that the market efficiency is balanced with the safety of the parties to the arrangement and third parties.

ii) Chapter V of Geneva Securities Convention

C.6. According to Article 31(1) of the Geneva Convention, Chapter V applies to collateral agreements, under which interests in intermediated securities are granted as collateral (collateral securities). The nature of the collateral under the Geneva Convention derives from the definitions of the relevant notions, which appear throughout the whole body of the Geneva Convention. In particular, ‘collateral securities’ are defined in Article 31(3)(e) as ‘intermediated securities delivered under a collateral agreement’, while under Article 1(b) ‘intermediated securities’ are presented as securities credited to a

71 For detailed analysis of the term ‘provision’ under the FCD and UK law, as well as of the eligibility of floating charges under the FCD, see Zacaroli, at p.p.168-170 and 180-182.
72 Zacaroli, at p.p.182.
73 T.R.M.P. Keijser, p.p.68, and Zacaroli also refers to the argument of the Law Commission, according to which “in order to satisfy the requirement of ‘control’ at least the collateral provider must be prevented (whether legally or practically) from dealing with the collateral”, Zacaroli, at p.p.182.
74 Recital (10) of Directive 2002/47/EC.
securities account or rights or interests on securities, held directly or indirectly by the investor,\textsuperscript{75} resulting from a credit to the relevant account. The provision determining the essence of ‘securities’ is placed under Article 1(a) of the Geneva Convention. The latter limits the material scope of the Geneva Convention to ‘shares, bonds or other financial instruments or financial assets (other than cash) which are capable of being credited to a securities account and of being acquired and disposed of in accordance with the provisions of this Convention’.

C.7. As it becomes clear from the combination of the aforementioned definitions, the material scope of the Geneva Convention includes securities, in the form of assets, which fulfill two conditions:

- first, are able to be held in securities accounts maintained by intermediaries, in other words indirectly held by the rightholders, and

- second, are subject to acquisition and disposition as prescribed by the Geneva Convention.\textsuperscript{76}

C.8. As to the types of financial instruments, the Geneva Convention does not enumerate the qualifying as collaterals instruments. Thus, it should be interpreted that eligible collaterals constitute bonds, debt instruments, shares, equity instruments, transferrable units other than shares in collective investment schemes and securitized derivative instruments.\textsuperscript{77} Since, no restrictive enumeration exists, it can be concluded that any financial instrument that arises from the market practice is included in the scope of the Geneva Convention, as long as it complies with the imposed criteria.\textsuperscript{78}

C.9. As to the exceptions from the application of the Geneva Convention, cash is explicitly\textsuperscript{79} excluded from the material scope.\textsuperscript{80}

C.10. As to the first criterium of applicability, which is the capability of securities to be credited to a securities account, this seems like a self-evident prerequisite, since the ‘intermediated securities’, as objects of the Geneva Convention, and their character, as ‘intermediated’, are created and acquired with the credit of securities to an account, held by an intermediary.\textsuperscript{81}

C.11. As to the second qualification, the capability of securities to be acquired and disposed according to the Convention, namely their transferability, depends on the holding of securities with the methods specifically addressed in the Geneva Convention.\textsuperscript{82} These are elaborated under Articles 11, 12 and 13 of the Geneva Convention, namely debit and credit, agreements with or in favor of the relevant intermediaries, designating entries and control agreements.

Further Limitation of GSC material scope

C.12. Chapter V of the Geneva Convention, as concerns its material scope, includes provisions with optional character. Such an opt-out clause is prescribed under Article 38. In particular, Article 38(2)(b)

\textsuperscript{76} GSC Official Commentary, par. 1-7.
\textsuperscript{77} GSC Official Commentary, par. 1-10.
\textsuperscript{78} GSC Official Commentary, par. 1-11, Chun, at p.p.39.
\textsuperscript{79} Article 1(a) GSC.
\textsuperscript{80} GSC Official Commentary, par. 1-7.
\textsuperscript{81} Chun, at p.p.40.
\textsuperscript{82} GSC Official Commentary, par. 1-12.
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Normal Application

C.13. The fundamental difference between the two instruments, apart from the disparity as to the intermediated character of securities, is that the Collateral Directive has broader scope of application, rationae materiae, because the kinds of financial instruments covered by it are more than those of the Geneva Convention, due to the nature and types of the eligible securities. The Geneva Convention applies to arrangements where the collateral consists only of interests in intermediated securities, whereas the Collateral Directive also permits credit claims and cash as collateral types.

C.14. A terminological issue should be clarified. This is the different terms that those instruments use. The Collateral Directive refers to the eligible types of collateral as ‘cash’, ‘financial instruments’ and ‘credit claims’ (Article 1(4)(i)), while the Geneva Convention refers to collateral as ‘an interest in intermediated securities’ (Article 31(1)). This difference is based on the willingness of Geneva Convention drafters to cover book-entries in securities accounts not representing full ownership, but a limited interest, such as a security interest, usufruct or life interest, which may arise from market practice. The aforementioned disparity is due to the intermediated nature of securities, that constitutes a determinative feature in the case of Geneva Convention.

C.15. As to the structure and wording, the Collateral Directive concentrates the provisions which define the material scope of application in one paragraph (Article 1(4)), while the Geneva Convention requires the reader to synthesize Articles 1, 31 and 38.

C.16. As to the central question of what types of securities constitute eligible collateral, the Collateral Directive refers to specific types of securities, without providing a definition of securities in general. In particular, the Collateral Directive enumerates the types of securities accepted as collateral in a restrictive way – ‘collateral…shall consist of cash, financial instruments or credit claims’ (Article 1(4)(i)) and then it defines them (Article 2(1)(d),(e),(o)). On the other hand, the Geneva Convention identifies eligible collateral with ‘interests in intermediated securities’ (Article 31(1)). This provision refers to article 1 of the Geneva Convention, which, in contrast to the Collateral Directive, provides the relevant – and general- definition of ‘securities’ to apply in its whole text. In relation to the content of ‘securities’, the Geneva Convention states in an indicative, and not in a restrictive, as the Collateral

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84 GSC Official Commentary, par.38-10. This conclusion derives from the combined reading of Articles 31(3)(e) and 1(b), which both cover tradable and non-tradable securities.
85 GSC Official Commentary, par.38-10.
86 See the comparison under A.5. and A.6.
87 Draft Commentary, par.1-7.
Directive, way the eligible types of collateral, namely ‘any shares, bonds or other financial instruments or financial assets’. However, because this definition, unlike the respective provision of the Collateral Directive, leaves margin of adding more types of financial assets, pursuant to the current market practice, it excludes explicitly ‘cash’ from the category of eligible collaterals. Once again, the Geneva Convention prefers to determine the scope by adding exclusions (negative manner), rather than stating, in a restrictive manner, the types of collateral, which are included (positive manner of defining), as is the case in the Collateral Directive. By determining only the limits of securities’ eligibility (by determining the exclusions), the Geneva Convention drafters restrict the national legislators only as concerns the content of the exclusions, and, in this way, they allow the Contracting States to formulate the rest of the rule (what is included), according to their domestic standards and practices. On the contrary, the EU Member States have no margins of discretion.

C.17. As to the requirement that the collateral taker is in control of the securities, both the Collateral Directive and the Geneva Convention include relevant provisions. Article 2(2) of the Collateral Directive considers as eligible only the securities, which are in the possession or under the control of the collateral taker. Similarly, Articles 11, 12 and 13 deem a security interest in securities as created, only when a debit or credit entry of these securities or an agreement with or in favor of the intermediary has taken place and, necessarily, the relevant intermediary has recorded the collateral taker as the holder of the interest or the intermediary became the holder of the very security, with the consequence that the collateral taker is control of the securities. However, the disparity between the two legal instruments is the use of different terminology, as the Collateral Directive refers explicitly to the need for possession or control by the collateral taker, whereas the Geneva Convention implies this requirement, since the latter is fulfilled simultaneously with the creation of the security interest in the securities.


C.18. As to the opt-out clauses, both legal instruments provide such possibilities to their Member States. The Collateral Directive provides the Member States with the options to exclude, from the material scope, the collateral provider’s own shares or shares in affiliated undertakings or undertakings with only purpose the ownership of means of production essential to the collateral provider’s business or the ownership of real property (Article 1(4)(b)) and credit claims when the debtor is a consumer or a micro or small enterprise (Article 1(4)(c)). On the other hand, the Geneva Convention allows the exclusion only of those ‘intermediated securities that are not permitted to be traded on an exchange or regulated market’ (Article 38(2)(b)). It is obvious that the difference is detected in the categories of securities, which are excluded. While the Collateral Directive allows the opt-out of shares of the collateral provider’s company and credit claims against consumer debtors, the Geneva Convention permits the exclusion only of non-tradable intermediated securities.

C.19. The Collateral Directive considers tradability as a prerequisite for securities to be eligible, in contrast to the Geneva Convention, which accepts the exclusion of tradable securities. Moreover, the

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88 See par. C.6.
89 The negative way, in which the GSC defines its scope, also appears in the personal scope. See par. B.7. and B.9.
90 This should be deemed as a practical application of the functional and also of the minimal approaches, adopted by the Geneva Convention.
Collateral Directive opt-outs concern categories of persons (collateral provider’s company etc and consumers), from which the securities (directly or indirectly) derive, whereas the Geneva Convention exclusion regards a specific function of securities, the tradability. However, in both cases, the opt-out clauses are added to address policy concerns. The difference is that the Collateral Directive pursues to protect the collateral provider from the economic unbalance, occurring in case of financial degradation of the company of the collateral provider, and serve consumer policy concerns, while the Geneva Convention responds to its Contracting States’ policy reasons, regarding the publicly traded securities in the national intermediated system.92

C.20. Furthermore, the Geneva Convention opt-out bears an absolute wording, with the meaning that it does not permit Contracting States to change the content of the declaration for non-application, in relation to how this declaration is drafted under Article 38(2)(b).93 In particular, a Contracting State may exclude only ‘the intermediated securities that are not permitted to be traded on an exchange or regulated market’. It is argued that the strict opt-out is not the case in the Collateral Directive, whose first opt-out (Article 1(4)(b)) leaves discretion to the Member States to decide which case to exclude from the material scope (collateral provider's own shares, shares in affiliated undertakings, 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).94 This can be deducted from the commas between the categories (‘Member States may exclude…collateral consisting of…collateral provider’s own shares, shares in affiliated undertakings, and shares in undertakings, whose exclusive purpose…to own means of production..or to own real property’).

92 GSC Official Commentary, par.29-14, 31-26, 38-10.
94 Chun, p.p.101. However, the writer of this Dissertation disagrees with Chun’s view. Since the aim of Article 1(4)(b) is to protect the collateral provider from the repercussions of its own financial degradation, any case in which the financial degradation of the shares issuer affects the collateral provider should be included or excluded, and such are all the cases that Article 1(4)(b) mentions. According to the Dissertation writer’s view there is no difference as to the absolute character of the opt-out.
D. MATERIAL SCOPE- RELEVANT OBLIGATIONS

i) The Financial Collateral Directive

D.1. The Collateral Directive also refers to the obligation which is secured by the financial collateral arrangement and specifies the qualifications of this obligation. In particular, under Article 2(1)(f), it denominates the obligations which are secured by a financial collateral arrangement as ‘relevant financial obligations’ and presents their attributes, in an exemplary way, in relation to three parameters, in order to ensure that various types of obligations are included.

1) According to the first parameter, the relevant obligations are viewed ratione temporis, and are considered acceptable by the Collateral Directive, if they are ‘present or future, actual or contingent or prospective obligations (including those arising under a master agreement or similar agreement)’ (Article 2(1)(f)(i)). Thus, the Collateral Directive covers relevant obligations, irrespective of when they were created - existing (present, actual) and also future (future, contingent, prospective), even if the latter are not even known at the time of the arrangement. 96

2) The second parameter is the ratione personae perspective, pursuant to which the collateral may cover an obligation owed not by its collateral provider, but by another, third, person (Article 2(1)(f)(ii)). Therefore, some effects of the Collateral Directive can be indirectly extended to other persons.

3) The third parameter refers to the type of the relevant obligations and states clearly that the material scope of the Collateral Directive includes obligations of specified classes, but also periodic obligations (‘arising from time to time’) (Article 2(1)(f)(iii)).

D.2. The only limitation, that the Collateral Directive imposes, concerns the manner in which the relevant obligations are extinguished. Article 2(1)(f) requires that the collateral taker is entitled under the secured transaction to request ‘cash settlement and/or delivery of financial instruments’ (Article 2(1)), so that the collateral provider can perform its obligations only in the aforementioned manner.

ii) Chapter V of Geneva Securities Convention

D.3. Chapter V of the Geneva Convention is also concerned with the underlying transaction, as the basis of the collateral agreement. In particular, Article 31(3)(d) Geneva Convention defines ‘relevant obligations’ as ‘any…. obligations of the collateral provider or another person’ to the collateral taker, so the collateral provider can secure the obligations of a third party. 97 In the definition are mentioned also some attributes of the relevant obligations as regards the time of their genesis, namely to the notion of ‘relevant obligations’ belong existing, future and contingent obligations or in other words obligations irrespective of when they arose.

D.4. As to the notion of ‘relevant obligations’, Chapter V does not seem to exclude any category of relevant obligations, since no such provision exists. However, in order to respond to the different

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97 GSC Official Commentary, par.31-24. which refers to the notion of contingent obligations in general.
98 GSC Official Commentary, par.31-23.
national policies, it leaves the addition of exclusions to the discretion of the Contracting States. In fact, under Article 38(2)(c), the Geneva Convention introduces a provision, which allows the Contracting States to declare that the Geneva Convention will not apply to collateral arrangements which secure specific categories of relevant obligations. Those categories are to be defined by the declaring state.

**COMPARISON OF THE COLLATERAL DIRECTIVE AND GENEVA CONVENTION**

D.5. As to their systemic position, the provisions on the ‘relevant obligations’ in both instruments, are placed under the ‘Definitions’ sections (Article 2(1) of the Collateral Directive and Article 31(3) of the Geneva Convention). Thus, the notion of the term has the form of a definition. However, under the Collateral Directive, the definition also includes limitations (Article 2(1)(f)first section) and examples (Article 2(1)(f)(i),(ii),(iii)), in contrast to the provision of the Geneva Convention which is almost pure definition (Article 31(3)(d)).

D.6. As to the types of relevant obligations, both the Collateral Directive and the Geneva Convention elaborate on them. The Collateral Directive presents some types of relevant obligations, as examples—in order to clarify the application scope—, which are divided in three categories, pursuant to each reference point. In particular, the Collateral Directive divides the exemplary types pursuant to the time, when they were generated (‘present or future, actual or contingent or prospective obligations’), their debtors (‘person other than the collateral provider’) and other elements concerning their performance (‘of a specified class or kind arising from time to time’). However, although Article 31(3)(d) of the Geneva Convention refers also to when the relevant obligations arise (‘existing, future or contingent’) and to the possible debtors of these obligations (‘of a collateral provider or another person’), it does not mention further attributes of the relevant obligations, such as the manner of the obligations’ performance in contrast to the Collateral Directive. In addition, the wording of Article 31(3)(d) of the Geneva Convention refers also to when the relevant obligations arise (‘existing, future or contingent’) and to the possible debtors of these obligations (‘of a collateral provider or another person’), but rather as defining the limits of the notion ‘relevant obligations’ (‘any existing, future or contingent obligations of a collateral provider or another person’).

D.7. As to the exceptions from the material scope, both instruments provide for cases of non-application but in a different way. The Collateral Directive requires, with positive wording, that the relevant obligations have a particular content, namely that they can be performed with ‘cash settlement and/or delivery of financial instruments’. This means that any collateral agreement securing a relevant obligation not providing for cash settlement and/or delivery of financial instruments is excluded from the application of the Collateral Directive (reverse exclusion). On the other hand, Article 38(2)(c) of the Geneva Convention also includes an opt-out in relation to ‘relevant obligations’, but with the negative wording of ‘shall not apply:…..c) in relation to collateral agreements that relate to relevant obligations…’. Furthermore, the Collateral Directive limitation applies automatically, since the European Commission drafted a provision with a very specified content, ‘cash settlement and/or delivery of financial instruments’, which it imposed to the Member States without allowing any

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discretion to them as to its implementation or formulation of content. On the contrary, the Geneva Convention does not impose any limitation by its own motion, but only creates the possibility of declaration (‘a Contracting State may declare that this Chapter shall not apply.’), allowing the declaring states, first, to decide if they need an exclusion (‘may declare’), and, second, specify which relevant obligations should be excluded from the application scope (‘categories as may be specified in the declaration’), thus leaving the definitive formulation of the provision to the Contracting States.
II. COMPATIBILITY OF THE EU FINANCIAL COLLATERAL DIRECTIVE AND CHAPTER V OF THE GENEVA SECURITIES CONVENTION

E. RIGHT OF USE

i) Financial Collateral Directive

E.1. After strong lobbying efforts by the derivatives and securities-trading unions, the Collateral Directive adopted the established in the United States securities practice of collateral re-use, in order to enhance liquidity, securities flow and cost efficiency inside the European Market. Under the Definitions section of the Collateral Directive the term ‘right of use’ is defined 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’ (Article 2(1)(m)).

E.2. Although the introduction of the ‘right of use’ in the European legal order was criticized as incompatible with the legal traditions of the Member States, a special provision was incorporated in the body of the Collateral Directive, in order to legitimize and guarantee the validity of the exercise of the ‘right of use’, by prohibiting national rules that put into question the validity of the corollary rights (Article 5(4)).

E.3. ‘Right of use’ is allowed, though, only under the condition that it is agreed by the parties to the collateral agreement (Article 5(1)).

E.4. The Collateral Directive balances the ‘right of use’ of the collateral taker by imposing an obligation on it. Article 5(2) obliges the collateral taker, if it exercises its ‘right of use’, to transfer during the period, starting on the day of disposal and ending on the due date for the performance of the relevant financial obligations covered by the security financial collateral arrangement, ‘equivalent collateral to replace the original financial collateral’. The purpose of this obligation of the collateral taker is to ensure that after the disposal of the original collateral, the collateral provider is not left with an unsecured claim, because its claim will be secured by the (re-)transfer of the equivalent collateral.

E.5. The Collateral Directive, under Article 2(1)(i)(ii), defines ‘equivalent collateral’ as:

1) ‘a payment of the same amount and in the same currency’, if the original collateral is cash, or by ‘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’

2) other assets, if three prerequisites are fulfilled: First, if the collateral consists of financial instruments and not cash, second, if the financial collateral arrangement provides so and third,

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102 As T.R.M.P.Keijser analyzes in his book, there are efforts to adapt the notion of the ‘right of use’ to the continental principles of proprietary law. The prevalent legal term used in Italian, Dutch, German and Greek law is ‘pignus irregulare’ (T.R.M.P.Keijser ZEuP, at p.p.315 and Pergamalis, at p.p.36, FN 23), while T.R.M.P.Keijser proposes the notion of a ‘general right of disposal’ (at p.p.231 and 235 and forth). The view of the writer of this Dissertation is that it should be deemed as an ‘mixed-type contract’ (gemischter Verträge), consisting of a normal pledge under the resolutory condition of the exercise of the second part of the contract, which would be a ‘Call Option’, being given effect when the collateral taker, who has the right but not the obligation (‘right of election to purchase’ - to acquire the ownership of the collateral in order to treat it as its owner (therefore also to dispose of it), he exercises this right.


‘following the occurrence of any event relating to or affecting any financial instruments provided as financial collateral’.

E.6. As a complementary to the obligation of the collateral taker for delivery of ‘equivalent collateral’, Article 5(2) introduces an alternative obligation for the collateral taker, if the (re)transfer of the equivalent collateral is not conducted during the aforementioned period (from the day of the exercise of the ‘right of use’ to the due date of the performance of the relevant obligations). The collateral taker has a ‘last chance’ to compensate the provider on the due date for the performance of the relevant financial obligations. That is to ‘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’.105

E.7. The Collateral Directive also allows the application of the ‘close-out netting’ provision (Article 7), if the collateral taker has not (re)transferred the equivalent collateral to the collateral provider and an ‘enforcement event’ occurs before the due date for the performance of the relevant obligations (Article 5(5)). As ‘enforcement event’ is considered 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 ……, ……. a close-out netting provision comes into effect’ (Article 2(1)(l)). However, even the ‘close-out netting’ may not compensate the collateral provider, if, in the meantime between the exercise of the ‘right of use’ and the occurrence of the ‘enforcement event’, the prices of the original collateral have substantially increased and no margin agreements to balance the exposures exist.106

E.8. As to the legal regime of the ‘equivalent collateral’, Article 5(3) of the Collateral Directive requires that the equivalent assets are subject to the same terms of the collateral agreement as the ‘original collateral’ and are considered as having being owned by the collateral provider from the outset of the transaction (‘proprietary substitution’). The ‘proprietary substitution’ produces effects also for the collateral taker, who is deemed to have a security interest on the ‘equivalent collateral’ from the beginning of the transaction.

E.9. As concerns the rights of the collateral provider after the exercise of the ‘right of use’ on behalf of the collateral taker, the former remains with a contractual claim (right in personam) after the latter exercises its ‘right of use’, because the collateral provider’s bond with the original collateral (right in rem) is broken.107 The collateral provider does not seem to be granted with any equity of redemption, such as the revival of its property rights in the ‘original collateral’.108 In other words, if the collateral taker does not deliver ‘equivalent collateral’, the collateral provider is left with an unsecured claim, which means that in case of the collateral taker’s insolvency, it will be satisfied pari passu with the other unsecured creditors.109 However, the contractual claim of the collateral provider can be set-off against the relevant obligation (Article 5(2) second subparagraph) on the due date for the performance of the

105 But see Johansson Property, at p.p.16, where she interprets the provision as “at best can be set-off against the underlying obligation at least until the equivalent collateral has been acquired or transferred”. The writer is of the opinion that there is no standing possibility of set-off, since the wording of the provision states “on the due date”, interpreted as the specific day when the relevant obligations are agreed to be discharged.
relevant obligations or it can be submitted to ‘close-out netting’ with the value of the relevant obligations if an enforcement event takes place.\textsuperscript{111} The problem of the collateral provider arises in the case of over-collateralization, which takes place either when the collateral provider has posted too much collateral or the price of the original collateral increased significantly.\textsuperscript{112}

In any case, though, it can be assumed that the balance between the parties to the collateral agreement is distorted, since the collateral taker is secured throughout the whole duration of the transaction–initially, with the original collateral and then, with the maintenance of its right of use also in the ‘equivalent collateral’ (‘proprietary substitution’)-, while the collateral provider is left basically unsecured and the possibility of it being secured at some point in the course of the transaction depends on the collateral taker, if and when it delivers the ‘equivalent collateral’.\textsuperscript{113} Otherwise, it is obliged to wait for the due date for the performance of the relevant obligations to come, so that it can be secured with the ‘equivalent collateral’ or set-off. But even if the collateral provider applies the alternative remedy of set-off or the close-out netting, it bears the risk of partial compensation, if there is insufficiency of the collateral taker’s assets.

\textit{ii) Chapter V of Geneva Securities Convention}

\textbf{E.10.} For reasons of promoting the use of services, such as securities lending and prime brokerage arrangements,\textsuperscript{114} of pursuing more financial growth, secured finance and securities-trading optimization,\textsuperscript{115} the Geneva Convention regulates the collateral taker’s ‘right of use’ (Article 34), and obliges the Contracting States to ensure that the exercise of the ‘right of use’ will not render invalid or unenforceable the rights arising out of its exercise (Article 34(4)). The Geneva Convention derogates from the national laws, which prohibit the disposal of the assets when they are given as collateral, under a pledge contract, to secure the recourse of the collateral provider to the collateral.\textsuperscript{116}

\textbf{E.11.} Article 34(1) features the definition of the right of use as the collateral taker’s ‘right to use and dispose of the collateral securities as if it were the owner of them’, ‘if and to the extent that the terms of a security collateral agreement so provide’. This means that, only if the collateral provider has provided its consent under the collateral agreement, the collateral taker can sell the collateral, lend it, pledge it to a third party or dispose of it in any other way.\textsuperscript{117}

\textbf{E.12.} Article 34 also specifies the obligations arising, when the collateral taker exercises its ‘right of use’ by using or disposing of the already provided collateral (‘original collateral securities’). Accordingly, the collateral taker is obliged to transfer to the collateral provider, in order to avoid leaving the latter unsecured, the following assets:

a) ‘Equivalent collateral’, with the meaning of ‘securities of the same description as collateral securities’ (Article 31(3)(i)), or

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\textsuperscript{111} Johansson Property, at p.p16.
\textsuperscript{113} This imbalance becomes provocative, when collateral-takers are powerful banks and collateral providers are small and medium sized enterprises, see Johansson Property, at p.p16.
\textsuperscript{114} GSC Official Commentary, par.34-13.
\textsuperscript{115} GSC Official Commentary, par.34-1.
\textsuperscript{116} GSC Official Commentary, par.34-12.
\textsuperscript{117} GSC Official Commentary, par.34-13.
b) Other assets, ‘if the security collateral agreement provides for the delivery of other assets’ (Article 34(2)), but such ‘other assets’ may be provided only ‘following the occurrence of any event relating to or affecting any securities delivered as collateral’, when ‘securities of the same description as the original collateral’ (Article 31(3)(i)) are hardly or not available, such as in the case of a merger or a take-over concerning the issuing company. Thus, the provision of ‘other assets’ is a restricted possibility.

Both ‘equivalent collateral’ and ‘other assets’ are qualifying as ‘replacement collateral’.

E.13. The ‘replacement collateral’ should be provided inside a specific timeframe. Chapter V of the Geneva Convention requires the delivery of the ‘replacement collateral’ to be done not later than the discharge of the relevant obligations (Article 34(2)). Thus, the obligation of (re-)transfer exists from the moment of the exercise of the ‘right of use’, with the disposal of the original collateral, until the moment of the actual discharge of relevant obligations.118

E.14. For the case, when an ‘enforcement event’ occurs during the period, in which the obligation for the delivery of ‘replacement collateral’ remains outstanding and the relevant obligations have not been discharged yet, Article 34 contains no provision. Instead, all enforcement issues are dealt under Article 33, which provides under Paragraph 2 for ‘close-out netting’ as a solution to the aforementioned case. As ‘enforcement event’, Chapter V considers ‘in relation to a collateral agreement, an event of default or other event on the occurrence of which, under the terms of that collateral agreement...a close-out netting provision may be operated’ (Article 31(3)(h)). Although, the ‘close-out netting’ can be a form of redemption for the collateral provider, there is the risk that the latter suffers a loss, if the value of the ‘replacement collateral’ which should have been transferred is higher than that of the relevant obligations.119

E.15. As to the rights in the ‘replacement collateral’, Article 34(3) of the Geneva Convention provides that the same terms and manner as the original collateral are applied also to the ‘replacement collateral’ and that the latter is provided with retroactive force, namely its delivery should be considered as performed from the same temporal moment,120 as in the case of the original collateral.121 The rationale behind this rule is the exclusion of the possibility that the ‘replacement collateral’ is presented as new, with the respective legal consequences, especially in the priority of security interests.122

E.16. It should be highlighted, that the collateral taker’s ‘right of use’ may have an adverse impact on the legal situation of the collateral provider, who loses its proprietary interest in the ‘original collateral’, being left only with a contractual claim until the moment, when the collateral taker delivers ‘replacement collateral’.123

However, the Geneva Convention with its provision under Recital 10 of its Preamble, allows the Contracting States to limit the ‘right of use’ in their territories, through the imposition of regulatory or

118 GSC Official Commentary, par.34-3.
120 Thus, replacement collateral is subject to an interest, which is estimated from the time it would be estimated for the original collateral and under the provisions of the collateral agreement for the original collateral (Article 34(3)(a)).
121 GSC Official Commentary, par.34-4.
122 GSC Official Commentary, par.34-16.
123 GSC Official Commentary, par.34-1.
supervisory restrictions, for reasons of investor protection and prevention of excess liquidity, as long as the provisions of the Geneva Convention are not contravened.\footnote{GSC Official Commentary, par.34-3.} In other words, the Contracting States may impose permanent or temporary restrictions on the ‘right of use’, as long as these respect the core rules of the Geneva Convention and have as purpose to protect the investors and the financial system.\footnote{See GSC Official Commentary, par.34-13.} It can be deducted that the ‘right of use’ cannot be annulled by the Contracting States, but it can be complemented with more or stricter obligations, which a Contracting State may be willing to impose to the collateral takers, such as the obligation to conduct a set-off against or apply the value of the ‘replacement collateral’ in discharge of the relevant financial obligations.

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**E.17.** From a teleological perspective, both the Collateral Directive and the Geneva Convention include provisions for the ‘right of use’ for an identical reason, the enhancement of liquidity in the financial market, by facilitating the circulation of collateral and the optimization of its use with the legitimization of the re-use method. In order to achieve the aforementioned legitimization, both legal instruments impose to the Member or Contracting States the obligation to ensure that the exercise of the ‘right of use’ does not render invalid or unenforceable the rights of the collateral taker under the relevant collateral agreement (Article 5(4) of the Collateral Directive and Article 34(4) of the Geneva Convention).

**E.18.** As to the structure, Article 5 of the Collateral Directive leads to the Definitions section (Article 2), where the ‘right of use’ is explained (Article 2(1)(m)). On the other hand, Chapter V of the Geneva Convention presents the notion of ‘right of use’ only under Article 34. In addition, regarding the ‘close-out netting’ provisions, the Collateral Directive contains a close-out netting provision tailored to the right of use (Article 5(5)), the Geneva Convention deals with close-out netting in the context of Article 33, relating to enforcement generally.

**E.19.** As to the terminology used, a slight difference exists: while the Geneva Convention considers as ‘replacement collateral’, the ‘equivalent collateral’ and the ‘other assets’ (Article 34(2)), and as ‘equivalent collateral’ securities of same description as the original ones (Article 31(3)(i)), the Collateral Directive has one definition, that for the ‘equivalent collateral’, which includes both the securities of same characteristics with the original collateral and the other assets (Article 2(1)(i)).

**E.20.** As concerns the types of the ‘equivalent’ or ‘replacement’ collateral,\footnote{Johansson argues that the Geneva Convention “goes further than Article 5 of the Financial Collateral Directive in that ... (it) gives the parties the right to agree to deliver collateral of a different type than the collateral originally provided”. See Johansson, at p.p.160. This is not entirely accurate, as the Collateral Directive also provides for ‘other assets’, if the original collateral consists of financial instruments, under certain circumstances and if the parties have agreed relevantly. See above E.1 a).} both the Collateral Directive and the Geneva Convention include provisions allowing ‘other assets’ as ‘equivalent’ or ‘replacement collateral’, if certain events take place and if the collateral agreement provides for it. The only difference is that the Collateral Directive allows the provision of ‘other assets’ only if the original collateral was financial instruments and not cash. The choice between financial instruments and cash
would not be possible under the Geneva Convention, since the latter does not include cash in its material scope.

E.21. As to the substantive law, both legal instruments provide for a new rule, common in both. The rule is the introduction of the right of the collateral taker to use the collateral provided by the collateral provider (Article 5(1) of the Collateral Directive and Article 34(1) of the Geneva Convention. Both of these instruments, though, add a limitation to the ‘right of use’, according to which ‘party autonomy’ can only legitimize the ‘right of use’ and its exercise, namely this right can be exercised only when this is agreed by the parties to the collateral agreement, more specifically, when there is the collateral provider’s consent to the ‘right of use’. Moreover, both instruments introduce an obligation complementary to the right of use, according to which after the exercise of this right the collateral taker bears the obligation to re-transfer back to the collateral provider equivalent or replacement collateral (Article 5(2) of the Collateral Directive and Article 34(2) of the Geneva Convention).

E.22. However, slight differences are detected in the provisions of those legal instruments, regarding the delivery of ‘equivalent’ or ‘replacement collateral’.

E.23. As concerns the period in which the ‘equivalent’ or ‘replacement collateral’ should be provided, under the Collateral Directive, the collateral taker can perform its obligation for provision of ‘equivalent collateral’ from the date it exercised its ‘right of use’, until and on the due date for the performance of the relevant financial obligations (Article 5(2)first subparagraph). The Geneva Convention, though, provides that the delivery of the ‘replacement collateral’ should take place after the date, when the ‘right of use’ was exercised, but ‘not later than the discharge of the relevant obligations’. It is not clarified if the ‘discharge’ term represents a date or a period, but it is argued that the ‘discharge’ refers to the actual fulfillment of the collateral taker’s obligations and can concure with the due date of performance, but it can also occur earlier or even later than the due date.\textsuperscript{127} However, if the parties have drafted the collateral arrangement properly, this disparity between the above terms (‘due date’ and ‘discharge’) is unlikely to have practical consequences, because non-performance on the ‘due date’ shall usually trigger close-out netting and thus lead to the ‘discharge of the relevant obligations’.

E.24. As to the case, in which the collateral taker has not delivered the ‘equivalent’ or ‘replacement collateral’ until the due date for the performance of the relevant obligations, the Collateral Directive provides three alternative choices. Apart from the transfer of the ‘equivalent collateral’, the Collateral Directive states that, if the parties have agreed and to the extent they have done so, the collateral taker can, on the due date for the performance of the relevant obligations, either set off the value of the ‘equivalent collateral’ against or apply it in discharge of the relevant financial obligations (Article 5(2) second subparagraph). Nevertheless, Chapter V of the Geneva Convention is silent on the possibilities of set-off and of application in discharge. There is Article 30, but this allows set-off but only in case of insolvency. However, the Geneva Convention contains a provision in its Preamble (Recital 10), which allows the Contracting States to limit the rights deriving from the exercise of the ‘right of use’ on behalf of the collateral taker, and consequently to provide more protection to the collateral provider. In these

frames, practices such as the set-off or the application in discharge could be accepted by the Geneva Convention.

**E.25.** As to the close-out netting possibility, both the Collateral Directive, under Article 5(5), and the Geneva Convention, under Article 33(2), confirm the availability of ‘close-out netting’ between the relevant obligations on behalf of the collateral taker and the obligation for the delivery of ‘equivalent collateral’ on behalf of the collateral taker, if an ‘enforcement event’ occurs. As to the meaning of the ‘enforcement event’, it is almost identical in both legal instruments, defined as an event of default or any similar/other event as agreed between the parties/under the terms of the collateral agreement on the occurrence of which, under the terms of a financial collateral arrangement, a close-out netting provision comes into effect/may be operated (Article 5(5) of the Collateral Directive and Article 31(3)(h) of the Geneva Convention).

**E.26.** By providing for ‘replacement collateral’ delivery until the actual discharge of the relevant obligations, the Geneva Convention deteriorates the legal position of the collateral provider for two reasons: first, the discharge may occur later than the due date of performance or may take place in parts, with the consequence that the collateral provider remains without or with partial recourse to an asset until that later stage, having only a contractual claim against the collateral taker, and second, that provision exerts indirect pressure to the collateral provider, as it moves the burden for the earliest possible performance on the latter, which should try to perform the relevant obligations as soon as possible in order to re-gain a recourse on an asset. In relation to these effects, the Collateral Directive seems more collateral provider-friendly, as it limits the non-delivery of ‘equivalent collateral’ by the collateral taker to the due date.

**E.27.** Moreover, both legal instruments, with a slight difference in wording, accept the ‘proprietary substitution’, namely they both are of the view that the securities delivered as ‘equivalent’ or ‘replacement collateral’ should be subject to the same legal regime as the ‘original collateral’, in particular to the same terms as the ‘original collateral’ and with retroactive force – from the outset of the transaction- (Article 5(3) of the Collateral Directive and Article 34(3) of the Geneva Convention).
F. TRIGGERS FOR THE PROVISION OF TOP-UP COLLATERAL

i) Financial Collateral Directive

F.1. The Collateral Directive pursues to maintain the economic balance between the parties to the collateral agreement. In this context, the Collateral Directive recognizes and protects from the ‘timing claw back rule’ clauses, which aim at keeping the parties’ exposures to the minimum, by imposing on the collateral provider and the collateral taker, the obligation to post additional collateral or financial collateral, respectively (‘top-up collateral’-Article 8(3)(a)). The obligation for provision of additional collateral and financial collateral should be included in the collateral arrangement, namely should be a result of parties’ consent.

F.2. Both ‘top-up’ provisions have two aspects:

1) The provision of additional collateral constitutes an obligation on behalf of the collateral provider and a right in favor of the collateral taker, and has as its purpose the mitigation of the exposure of the collateral taker, if the value of the ‘original collateral’ decreases or if the value of the relevant obligations increases, and

2) The provision of financial collateral constitutes a right in favor of the collateral provider and an obligation on behalf of the collateral taker to post financial collateral –for the first time- in order to return the excessive value of the ‘original collateral’ to the collateral provider, if the value of the ‘original collateral’ increases or if the value of the relevant obligations decreases.

Since both cases of margin transfers provide rights and obligations for both parties to the collateral agreement, the collateral provider and the collateral taker, it can be assumed that the Collateral Directive provides for protection in both directions of the financial collateral relationship, in its pursuit of economic balance between the parties to the collateral arrangement.

F.3. In Article 8(3)(a), the Collateral Directive specifies the standard, on the basis of which the provision of ‘top-up’ collateral is conducted. This standard is the occurrence of ‘changes in the value of the financial collateral or in the amount of the relevant financial obligations’. In other words, the exposure of the parties is allowed to be covered with margin transfers, only due to the objective reason of the price fluctuations in the market. Thus, other cases, such as the occurrence of changes in the rating of the creditworthiness of one of the parties, are not considered as standards triggering the provision of ‘top-up’ collateral.

F.4. This limitation derives from the view of the European Commission that possible degradation of the creditworthiness status of the additional collateral provider would endanger its solvency and in case of a relevant failure, the protection provided by the Collateral Directive to the additional collateral taker would undermine the position of other creditors of the collateral provider. However, it is possible that the aforementioned limitation can be circumvented, when the collateral provider’s creditworthiness is

131 T.R.M.P. Keijser, at p.p 75-76.
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directly linked with the value of the collateral and such as in the case when the collateral provider is a company giving as collateral its own shares. In fact, the avoidance of such a contingency could be the rationale, behind the provision of Article 1(4)(b) of the Collateral Directive, which allows the exclusion of this kind of securities from the material scope of the Collateral Directive.

ii) Chapter V of Geneva Securities Convention

F.5. The issue of losses due to the exposures of parties to a financial collateral agreement is also addressed by the Geneva Convention, which allows the mitigation of these exposures by margin transfers and exempts those margin transfers from the retroactive force of insolvency (Article 36(1)(a)). The recognition and protection of the ‘top-up’ collateral transfers by the Geneva Convention can take place, only if the obligations for the margin transfers are agreed by the parties in their arrangement.

F.6. Article 36(1)(a) allows those collateral arrangement clauses, which provide for the provision of additional collateral securities, in case of change in the balance of the parties’ exposures. Noteworthy is that Article 36(1)(a) refers to the provision only of additional collateral and not also of financial collateral. From this wording, what can be deducted is that there is only one obligation and one right in relation to the provision of additional collateral. Since the delivery of additional collateral requires previous delivery of ‘original collateral’, it is obvious that the obligation is imposed on the collateral taker, who provides the ‘original collateral’, and the right is created in favor of the collateral taker. As it derives from the wording of Article 36(1)(a), the latter bears no obligation of margin transfer. Therefore, it can be argued that Article 36 protects the collateral relationship only towards one direction, that of the collateral taker.

F.7. The Geneva Convention accepts margin transfers, for the balancing of the collateral taker’s exposure only if the latter arises from the following events:

i. There are ‘changes in the value of the collateral delivered under the collateral agreement or in the amount of the relevant obligations’ (Article 36(1)(a)(i)), arising out of the comparison between the value of the original collateral at the time of its delivery and the value of the original collateral at the time, when the additional collateral is provided. The value of the relevant obligations is estimated in relation to the value of the collateral securing them. In other words, under this provision, an objective criterium, such as a change in the market prices, can trigger a margin transfer to cover the collateral taker’s exposure.

ii. An increase takes place ‘in the credit risk incurred by the collateral taker as determined by reference to objective criteria relating to the creditworthiness, financial performance or financial condition of the collateral provider or other person by whom the relevant obligations are owned’.

In this case, object of the estimation are not the collaterals or the relevant obligations, but the

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132 GSC Official Commentary, par.36-14, referring to the specific example.
133 See par. C.2(a).
134 GSC Official Commentary, par.36-12.
136 GSC Official Commentary, par.36-15.
very entity of the collateral provider or the debtor of the ‘relevant obligations’.\footnote{GSC Official Commentary, par.36-18.} In particular, the outcome, as to the increase of collateral taker’s credit risk, will not arise out of objective\footnote{GSC Official Commentary, par.36-18.} and quantitative parameters, but out of their connection to a single subject\footnote{GSC Official Commentary, par.36-19.} (qualitative criterium).

Article 36(1)(a)(ii) is deemed challenging for jurisdictions, which are highly concerned with insolvency issues, especially with the equality of insolvency creditors -\textit{paritas creditorum}- and the avoidance of fraud against them, as the deterioration of the financial condition may omen insolvency.\footnote{GSC Official Commentary, par.36-20.} Therefore, the drafters of the Geneva Convention recognized that some Contracting States would be unwilling to incorporate Article 36(1)(a)(ii), so they introduced an exclusion possibility\footnote{GSC Official Commentary, par.36-21.}. Accordingly, Article 36(2) leaves to the discretion of the Contracting States the choice to apply the creditworthiness standard in their territory, if they consider the protection of the collateral taker in case of the collateral provider’s credit risk deterioration as unworthy of being excluded from the ‘zero hour rule’.\footnote{Mooney- Kanda, at p.p.128.}

iii. Finally, the Geneva Convention applies to collateral arrangements providing for provision of additional collateral, when other circumstances occur, which are agreed and specified by the parties to the collateral agreement, to the extent permitted by the law applicable\footnote{In the text of the GSC it is referred to as ‘Non-Convention law’, which according to Article 1(m)GSC is the substantive law of the Contracting State. However, in the Official Commentary it is interpreted as the “substantive law of the Contracting State, which may apply...”.} to the collateral agreement.\footnote{Article 36(1)(a).} The crucial issues of this provision are first, that the insolvency benefit of ‘timing claw back rule’ of the Geneva Convention can be extended to more cases,\footnote{GSC Official Commentary, par.36-20.} depending on the free will of the parties (parties’ autonomy) and second, that the only limitation to their parties’ autonomy is the applicable law of the collateral arrangement\footnote{GSC Official Commentary, par.36-20.}. More specifically, the Geneva Convention does not impose limits or criteria by its own motion to the applicability of arrangements including obligations for additional collateral to cases of indeterminate number and content. It moves the burden of ‘watchdog’ to the national legislators, which are responsible to apply their \textit{ius cogens} and determine the scope of application of this specific provision.

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F.8. From a structural point of view, there is a difference in the position of the ‘top-up’ provisions in each legal instrument. While the Collateral Directive places the triggers of margin transfers and their protection under an article with general title and content (Article 8- ‘Certain Insolvency Provisions Disapplied’), the Geneva Convention includes an autonomous article, Article 36, for the regulation of...
margin transfers, which contains all relevant provisions as to the requirements of title transfers, the cases which trigger them and their protection from insolvency rules.

F.9. From a view of substantive law, both legal instruments recognize and protect form the ‘timing claw back rule’ the obligation for the delivery of financial or additional collateral, in order to mitigate the exposures of the parties to the collateral agreement, under the condition, though, that the aforementioned obligation is agreed by the parties in the collateral agreement.

F.10. While both legal instruments regulate margin transfers in order to protect the parties to a collateral agreement from the losses which they may suffer due to the increase of their exposures, the scope of protection differs. The Collateral Directive contains protective rules in both directions of a collateral transaction, as it provides for the delivery of both financial collateral and additional collateral, which means that both the collateral provider and the collateral taker are entitled to receive collateral, in case of exposure. On the contrary, Article 36 of the Geneva Convention grants protection only towards the one direction of a collateral arrangement, since according to its rules only the collateral taker is entitled to additional collateral to cover its exposure.

F.11. Another discrepancy is detected in the content of the ‘triggers’ of ‘top-up’ collateral provision. The Collateral Directive includes only one, in contrast to the three cases, which are elaborated by the Geneva Convention.

F.12. As to the first trigger, judging from the text of both the Collateral Directive and Geneva Convention, Article 8(3)(a) of the Collateral Directive and Article 36(1)(a)(i) of the Geneva Convention, have almost identical content and wording (‘in order to take account of changes in the value of the financial collateral or in the amount of the relevant financial obligations’ and ‘in order to take account of changes in the value of the collateral delivered under the collateral agreement or in the amount of the relevant obligations’). In other words, both legal instruments recognize obligations for the provision of financial or additional collaterals, in case of marking-to-market exposures.

F.13. The creditworthiness of the collateral provider constitutes the second ‘trigger’ for the provision of the additional collateral under the Geneva Convention (Article 36(1)(a)(ii)). The Collateral Directive, however, has not incorporated the creditworthiness of the collateral provider as a ‘trigger’ for ‘top-up’ collateral, on the grounds that a lower credit rating of the provider could raise fears of insolvency, in which case the provision of the ‘top-up’ collateral would be detrimental to the other creditors of the collateral provider.147 Willing to respond to similar concerns of the Contracting States, the drafters of the Geneva Convention added an opt-out provision under Article 36(2), according to which, this ‘trigger’ of ‘top-up’ collateral can be declared as non-applicable. If a State makes use of this clause, then the application scope of the Geneva Convention could approach the relevant application scope of the Collateral Directive.148

F.14. As regards the last ‘trigger’ of ‘top-up’ collateral included in the Geneva Convention, this widens the scope of application of the Geneva Convention, in contrast to the Collateral Directive, by allowing the parties to collateral arrangements to decide the posting of additional collateral on the occurrence of

147 T.R.M.P.Keijser, at p.p 75-76.
events, which they have personally agreed in the arrangement, if these agreements are not contrary to the applicable law of the arrangement (Article 36(1)(a)(iii)).
G. TREATMENT AFTER THE DECLARATION OF INSOLVENCY

i) Financial Collateral Directive

G.1. Article 8 of the Collateral Directive aims at safeguarding the validity of financial collateral transactions, if the collateral provider becomes subject to winding-up or reorganization proceedings. In winding-up proceedings the person who is unable to pay, has to liquidate all its assets to satisfy the claims of its creditors. In order to avoid the conduct of fraud against the latter, most jurisdictions include an “actio pauliana”, by which transactions made for the disposal of assets by the insolvent person with the purpose of making those assets unavailable to the creditors, can be declared void.

G.2. The Collateral Directive pursues to save, to the extent possible and justifiable, the validity of financial collateral transactions, to which it applies, on the grounds that these transactions have large-scale impacts in the economy and can cause systemic risk, while they are usually conducted between unknown entities in a very short time. This thought is hiding behind Article 8, which states in paragraph (1) and (3) that the conclusion of financial collateral arrangements and the provision of financial collateral and additional financial collateral, are protected from avoidance, if they take place prior to the initiation of winding-up proceedings, if no other reasons for avoidance exist.

G.3. However, Article 8(2) regulates what happens if the conclusion (or the coming into existence) of a financial collateral arrangement or of relevant financial obligations, as well as the provision of financial collateral take place ‘on the day, but after the moment of the commencement of winding-up procedures or reorganization measures’. Those transactions will be ‘legally enforceable and binding on third parties, if the collateral taker can prove that it was not aware, nor should have been aware’ of the aforementioned situation (Article 8(2)).

G.4. This provision focuses on the protection of “good faith” (bona fides) of the innocent acquirer, namely of the collateral taker. In particular, it aims at protecting a market participant in the financial market, from facing an unexpected avoidance of its transaction, because of its counterparty’s declaration of insolvency, of which it was not aware. According to this rationale, the provision is drafted so as to have a very limited scope of application:

a) Material scope: This includes only the conclusion of financial collateral arrangements, the conclusion of relevant financial obligations, and the provision of the initial financial collateral, as it is agreed in the collateral arrangement. Neither the provision of top-up collaterals, nor the substitution of provided collaterals are covered. This omission can be interpreted in two ways: Either there is a drafting mismatch or the European Commission intended to restrict the material scope of this provision. The first interpretation is based on the argument that if that restriction is imposed on the market participants, Article 8(2) will be of little use, because the practical importance of this rule relates to the protection of the collateral agreements as a whole, with any

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153 See Kotsiris, par.296, at p.p.416.
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subsequent obligation, until their termination. The second interpretation relies on the wording of the provision. It can be argued that because top-up collateral provision and substitution are dealt with under Article 8(3), if the drafters had the intention to extend the possibility of Article 8(2) they would add an analogous provision under paragraph 3 or they would draft Article 8(2) with a more general wording. In favor of the strict interpretation is also the fact that, when the Collateral Directive was amended, there was no provision changing Article 8(2).

b) Temporal scope: This particular provision of Article 8(2) of the Collateral Directive refers to the situation, in which the collateral transaction took place ‘on the day of, but after the moment of the commencement of, winding-up proceedings or re-organization measures’. This rule is innovative and new for some European jurisdictions, because it breaks the taboo of insolvency law, namely the presumption that after the declaration of the relevant proceedings, the counterparty of the insolvent person was aware of the winding-up proceedings. The reason is the extraordinary nature of the financial markets, where multiple market participants from various jurisdictions are involved and the transactions between them take place at a very fast pace.

c) Personal scope: That includes only the collateral takers, which can be considered as ‘innocent acquirers’. As such are deemed the collateral takers which were not aware and had no obligation to be aware of the commencement of winding-up procedure. However, no more hints are given for the notion and the standards of the ‘awareness’ or the ‘duty for awareness’. It should be highlighted, however, that the possibility of the collateral taker not being aware is quite small, since in financial markets there is immediate information on the potentially insolvent participants.

As a result of the above, the insolvent collateral provider can exclude some of its assets from the insolvent state, even after becoming subject to an insolvency administrator. This provision deteriorates the legal status of joint creditors, who aim at being satisfied from the insolvent estate, since it deprives them from the possibility of preventing the decrease of the estate assets, in favor of a creditor, which has a special category claim, that of financial collateral. Apart from the practical difficulties arising from this situation, it is clear that the Collateral Directive creates a new category of protected creditors or beneficiaries, on the basis of them being engaged in financial collateral transactions. This fact raises concerns of rule of law and international public order, since according to this specific provision the financial collateral takers will be satisfied prior and more easily in relation to other creditors belonging to sensitive categories, such as the category of the collateral provider’s employees. What is more, since the criterium of ‘good faith’ is quite vague, there is also the risk of the abuse of Article 8(2), if used as a ‘Trojan horse’ for the conduct of fraud against the insolvent estate creditors.

ii) Chapter V of Geneva Securities Convention

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154 Amending Directive, Article 2(8)-(9).
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G.5. In Chapter V of the Geneva Convention there are two articles, Articles 36 and 37, concerning the validity of a financial collateral transaction in relation to the commencement of insolvency proceedings against the collateral provider.

G.6. The first, Article 36, concerns the effects of the delivery of top-up collateral in relation to the collateral provider’s declaration of insolvency. According to this, the validity of the top-up delivery is protected, if the top-up provision takes place ‘during a prescribed period before, or on the day but before’ the declaration of collateral provider’s insolvency (Article 36(1)(b)). This provision includes nothing about the validity of the top-up collateral provision after the initiation of insolvency proceedings, and such a silence should be interpreted as not covering collateral provisions after the declaration of insolvency and as leaving the regulation of the issue to the discretion of the Contracting State.\(^{159}\)

G.7. The second provision, Article 37, covers every other collateral transaction that is not inside the scope of application of Article 36 – top-up collaterals-, namely the conclusion of collateral agreements or the delivery of collateral securities. As in Article 36, Article 37 refers to the same temporal scope, which is the prescribed period before or the day of the commencement of insolvency, but until the time when the latter takes place, and thus, should be interpreted likewise, as not covering the collateral provision or the conclusion of a collateral agreement after the commencement of collateral provider’s insolvency and leaving the issue to the national legislator.

G.8. However, the Geneva Convention includes a special article, which applies to acquisitions by ‘innocent acquirers’ (Article 18). In this, the Convention provides that the principle of ‘innocent acquisition’ can safeguard the validity of the securities transactions. Article 17(b) of the Geneva Convention guides its readers, willing to determine when the ‘innocence’ exists, that they ‘must take into account the characteristics and requirements of securities markets, including the intermediated holding system’.\(^{160}\)

G.9. One such case occurs when someone (the acquirer) has accepted a credit of securities or the grant of an interest in securities or intermediated securities, which, however, (the securities or intermediated securities) are subject to the interest of another person. If the acquirer does not know, or ought to know, at the relevant time, that

1. the securities it acquired are encumbered by someone else, and
2. that its acquisition violates the rights of that other person which has an interest in the same securities,

then it is considered an ‘innocent acquirer’, bearing no liability against that other person (Article 18(1)(b)). Furthermore, its rights or interests are not affected by the interest of that other person (Article 18(1)(a)) and there is no risk of declaring the acquisition void on the aforementioned grounds (Article 18(1)(c)). In other words, an acquirer is protected against any competing claim if it proves that it was unaware or had no obligation to be aware of that competing claim.\(^{161}\)

\(^{159}\) GSC Official Commentary, par.36-27.
\(^{160}\) GSC Official Commentary, par.17-11.
\(^{161}\) GSC Official Commentary, par.18-5.
Since this provision reflects a general principle, theoretically, it could be applied to a securities collateral transaction, if the latter takes place after the initiation of the insolvency proceedings.

G.10. After the commencement of the winding-up, the creditors of the insolvent party have rights against the insolvent state, which may include also intermediated securities. Therefore, these securities are encumbered with the rights and interests of the insolvency creditors. If the insolvent person enters a financial collateral transaction with a third party, right after the declaration of insolvency, it will grant an interest in or will dispose of securities, which are encumbered with the rights of the insolvency creditors, to that third party, which will acquire an interest or the ownership in these already encumbered securities. If that third party is unaware of the already existent interests due to the insolvency of the collateral provider, it may be considered as ‘innocent acquirer’ and may save its collateral transaction from invalidation, by using the provision of Article 18(1) of the Geneva Convention.

G.11. However, there is no explicit rule inside the Geneva Convention which links directly the principle of ‘innocent acquisition’ of Article 18 with the protection of collateral transactions in relation to insolvency of Articles 36 and 37. On the contrary, Articles 36 and 37, as they are interpreted, do protect collateral transactions from invalidation but with final deadline the moment of the insolvency commencement, but they do not allow their protection after that moment. Furthermore, Preamble (9) of the Geneva Convention includes a policy statement, according to which ‘this Convention is not intended to harmonize or otherwise affect insolvency law except to the extent necessary to provide for the effectiveness of rights and interests governed by this Convention’.

G.12. What can be deducted from the aforementioned provisions of the Geneva Convention, as well as from its ‘minimalist’ approach - according to which the minimum protection is ensured by the Geneva Convention but higher protection is welcome (Article 31(2))- is that the Geneva Convention leaves the determination of the rights of the collateral taker after the declaration of insolvency to the competence of the Contracting States, but it also pursues to provide the legal ground of ‘innocent acquisition’ (Article 18) to those Contracting States which will choose to protect the collateral taker after the commencement of the collateral provider’s insolvency. In other words it aims at facilitating the legal regimes, which are willing to provide more protection to the collateral taker.

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G.13. From a systemic point of view, the Collateral Directive places the rule for the protection of collateral transactions after the beginning of winding-up proceedings under the article for the disapplication of insolvency provisions, while the Geneva Convention contains no explicit provision for this specific issue.

G.14. As to the substantive law, whereas both legal instruments protect collateral transactions from being declared as void prior to the moment of insolvency commencement, they do not coincide in the provisions for the regulation of collateral transactions after the moment when the insolvency begins. The Collateral Directive rules, under Article 8(2), in a very clear manner, that financial collateral arrangements and relevant financial obligations can come into existence, as well as financial collateral

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62 GSC Official Commentary, par.36-27.
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can be provided (and other relevant transactions, if the wider interpretation is adopted) after the initiation of the collateral provider’s winding-up procedure, being legally enforceable and binding on third parties, if the collateral taker is in ‘good faith’. However, the Geneva Convention does not protect in an explicit way neither of the kinds of collateral transactions -collateral arrangements, original collateral or top-up provisions, substitutions- and is interpreted as not protecting them after the commencement of insolvency and as leaving the regulation of this issue to the discretion of the Contracting States.\(^{163}\) It could be supported though that the Geneva Convention facilitates the introduction of domestic legislation favorable to the validity of collateral transactions conducted after insolvency, with the inclusion of a general clause of ‘good faith’ (Article 18).

G.15. As to the principle of ‘good faith’, this is incorporated in the text of both the Collateral Directive and the Geneva Convention, but with different terms. The Collateral Directive refers to this principle, through the phrase ‘was not aware, nor should have been aware’. However, it does not refer to any legal instrument for its meaning, nor does it contain any definition of for its notion. On the other hand, the Geneva Convention not only has a special article for the ‘innocent acquisition’ (Article 18), where a similar phrase with the Collateral Directive is used, ‘actually knows or ought to know’, but also includes another article to provide guidance as to the determination of the notion of this phrase (Article 17(b)). Apart from this difference, the Collateral Directive limits the use of ‘good faith’ only in relation to insolvency, in contrast to the Geneva Convention, in which the article for ‘Acquisition by an innocent person’ covers all kinds of possible acquisitions under the Geneva Convention, except the gratuitous ones (Article 18(3)).

\(^{163}\) GSC Official Commentary, par.36-27.
III. CONCLUSION

CON-1. The previous Capital attempted to analyze the way in which the Collateral Directive and the Geneva Convention respond to the same issues. Incompatibility does not seem to exist, since the core in most topics is the same for both of these legal instruments, it is only the further provisions, which vary.

CON-2. As to the personal scope, both instruments cover major market participants, such as banks, financial institutions, investment firms, and, also, include minor market participants, in the form of Small- and Medium-sized enterprises. Their difference is that the Geneva Convention has a wider personal scope, as it includes natural persons and collateral agreements, where both parties are minor participants, which are covered by the Collateral Directive.

CON-3. Regarding the types of eligible collateral, the material scope is wider in the Collateral Directive, due to the fact that, apart from financial instruments, which are also covered by the Geneva Convention, cash and credit claims are also qualified as collaterals.

CON-4. In relation to the secured by the collateral arrangement obligations, the material scope of the Geneva Convention is broader, since it contains no limitation on the kind of secured obligations, such as the requirement that they should give right to cash settlement and/or delivery of securities, which is the case in the Collateral Directive.

CON-5. Concerning the provision to the collateral taker of the right to use the collateral, both instruments agree on this possibility and both impose on the collateral taker the obligation to post equivalent collateral. The Geneva Convention slightly differs from the Collateral Directive, as it allows a more flexible time-frame for the fulfillment of this obligation in relation to the Collateral Directive.

CON-6. Both legal instruments also respond to the need of the collateral taker to mitigate its subsequent exposure in relation to the collateral provider by the right to ask for additional (‘top-up’) collateral. The Geneva Convention provision is more favorable to the collateral taker than the Collateral Directive, since the former allows the top-up collateral provision in more cases. Namely, in the Geneva Convention a change in the collateral provider’s creditworthiness and circumstances agreed by the parties can justify the addition of further collateral, apart from the change in the value of the original collateral, which is the only justification under the Collateral Directive.

CON-7. Finally, in the insolvency field, there is no apparent similarity as to the way the collateral taker is protected. The Collateral Directive upholds the validity of a collateral arrangement, secured obligation or an original collateral provision, when it takes place on the day but after the collateral provider is declared insolvent, if the collateral taker was in ‘good faith’ as to the insolvency. The Geneva Convention does not provide this possibility.

CON-8. The issues covered by the Collateral Directive and the Geneva Convention are of great importance to the function of the financial markets, since they represent serious concerns of the market participants concerning the conclusion and performance of collateral arrangements in the transnational field. The provisions of the aforementioned legal instruments have the potential to respond to those challenges by attempting to eliminate the legal risk, through the harmonization of domestic laws. The
value of these attempts becomes apparent in the current discussion on the drafting of a ‘Securities Law Directive’, which is said to build on the language and the concepts of the Collateral Directive and the Geneva Convention.  

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