Financial Collateral Arrangements

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Abstract: Increasing use of securities and collaterals in transactions brings the legal ambiguity in today's financial markets which are trying to globalise. It should have been noted that without legal certainty an achievement can not be obtained in a complete manner. To solve this legal ambiguity in financial markets, reform movements have been started through out the world from different groups, institutions and communities involving both jurists and practitioners., The Directive on settlement finality in payment and securities settlement systems and the Directive on financial collateral arrangements were adopted. These two directives are both supplementary legislations for the Directive of the Parliament and of the Council on the reorganisation and winding up of credit institutions dated 4 April 2001. All of these directives are the circles of a chain that aim the proper functioning of the internal financial market in European Union. In this study, mainly the Collateral Directive will be taken into account. Firstly, the necessity of a harmonised collateral law and the aims of the Collateral Directive will be handled. Following, the main provisions of the directive will be analysed in details. While analysing in details, the different implementations of the directive in member states will be mentioned. Finally, the conflict of laws clause and the consequences of the directive will be explained.

1. INTRODUCTION

Reforms in insolvency law have triggered the significance of collateralisation which can be deemed as a primary risk mitigation technique gaining much importance day by day. Financial institutions carry on cross-border trading without the restrictions of exposure limits by taking and giving collaterals which cover all or part of those credit exposures. (Coiley, 2001) The value of collateral held by the European Central Bank at the beginning of the 2000 was 550 billion US dollars and nearly the 160 billion dollars of this amount was held on cross-border transactions.(Summe, 2001) These gigantic totals well illustrate the importance of collateralisation on financial markets.

Increasing use of securities and collaterals in transactions also brings the legal ambiguity in today's financial markets which are trying to globalise. It should have been noted that without legal certainty an achievement can not be obtained in a complete manner. To solve this legal ambiguity in financial markets, reform movements have been started through out the world from different groups, institutions and communities involving both jurists and practitioners. [1]

The Directive on settlement finality in payment and securities settlement systems (Directive 1998/26/EC of the European Parliament and of the Council of 19 May 1998 on Settlement Finality in Payment and Securities Settlement System [1998] OJ L166/45, hereafter cited as the Settlement Finality Directive) and the Directive on financial collateral arrangements (Directive 2002/47/EC of the European Parliament and of the Council on Financial Collateral Arrangements [2002] OJ L168/43, hereafter cited as the Collateral Directive) were adopted. These two directives are both supplementary legislations for the Directive of the Parliament and of the Council on the reorganisation and winding up of credit institutions dated 4 April 2001(Directive 2001/24/EC of the European Parliament and of the Council on Reorganisation and Winding up of Credit Institutions [2001] OJ L125/15, hereafter cited as the Reorganisation and Winding up Directive). All of these directives are the circles of a chain that aims the proper functioning of the internal financial market in European Union. In this paper, mainly the Collateral Directive will be taken into account as the subject of this paper is collateral arrangements. Firstly, the necessity of a harmonised collateral law and the aims of the Collateral Directive will be handled. Following, the main provisions of the directive will be analysed in details. While analysing in details, the different implementations of the directive in member states will be mentioned. Finally, the conflict of laws clause and the consequences of the directive will be explained.

[1] For instance International Swaps and Derivatives Association(ISDA) organizes a Collateral Reform Group, European Financial Market Lawyers Group(see www.efmlg.org for the comments and statements on collateral directive), Giovannini Working Group inside EU, and UNIDROIT also working on a uniform law regarding to transactions on transnational and connected capital markets.

2. NECESSITY FOR A HARMONIZED COLLATERAL LAW

Collaterals have became the vital instruments for the modern financial markets as they are used nearly in all types of transactions such as; bank treasury and funding, payment and clearing systems, repurchase agreements, general bank lending and etc (Lober & Klima, 2006). It is stated in the tenth semi-annual survey of the *repo* market that the EU *repo* market size is now estimated to be in excess of Euro 5.8 trillion.[2] Creditors naturally want to obtain enforceable and valid collaterals to reduce their credit risk. In payment and securities settlement system, collateral is the major mechanism to decrease the systemic risk (Lober & Klima, 2006).

Collateral can be in the form of the cash or securities and when it comes to dematerialised securities, the problems start to emerge. In classical "direct holding systems", the owner of a security has direct relationship with the issuer. However, "indirect holding systems" which are very commonly used in nowadays transactions, consist of more then one tier of intermediaries between issuer and investor. As a result of this multiple securities and multiple layers of intermediaries occur. When a problem arises like opening of the insolvency proceedings against one of the parties, it becomes a very sophisticated issue because each state has its own law regarding to above mentioned issues. In addition to this, not only substantive laws of the states vary from each other, but also conflicts of laws approaches vary. (Einhorn & Siehr, 2004) Hence, different national laws may apply to separate parts of the transactions. For instance, assets provided as collateral may situate in one state, debtor's domicile can be in another state, debt can also be governed by a third state. Indirect holding systems make it much more sophisticated as an indirect holding system may consist of a lot of tiers like, international central securities depositories, financial institutions, brokers, individual investors and etc.[3]

The Finality Settlement Directive and the Collateral Directive have been adopted as a solution for the above mentioned situations that would probably hamper the internal financial market. Although the Finality Settlement Directive constituted a milestone for payment and securities system, it has a rather restricted scope and only covering some types of collateral arrangements. Because of this, a new action was started to create legislation on collateral arrangements that would go beyond the scope of the Finality Settlement Directive, after taking consultations from market experts and national authorities. (The Collateral Directive, recital 2)

3. FINANCIAL COLLATERAL ARRANGEMENTS DIRECTIVE

3.1 Main objectives of the Directive

The aim of the directive is to contribute the stability and cost-efficiency of financial market, so that the free movement of capital in the single market will be provided. It also aims to ease the implementation of the common monetary policy. This can be achieved by fostering the efficiency of the cross-border transactions of the European Central Bank and permitting the participants in the money market to balance the comprehensive amount of the liquidity in the market among themselves. (Asgeirsson, 2003/4) The main objectives of the directive are: (Vereecken & Sylvia Kierszenbaum, 2005; Turing, 2007).

- Removing certain obstacles to the efficient use of collateral arrangements by limiting the formalities for the creation or enforcement of the financial collaterals. So that the burdens in the national laws regarding to the form, validity, completion and substance of collateral arrangements would be abolished (Collateral Directive, article 1(2)(a)-(d)),
- Supporting the protection of collateral arrangements from insolvency and reorganization rules,
- The reuse of the collateral is allowed as if collateral takers owned it,
- Recognizing the title transfer of the collateral arrangements and close-out netting structures,
- Enlighten the issue of the applicable law to book-entry securities collateral by stating that the governing law shall be the law of the country where the securities account is maintained.

3.2. Scope

3.2.1. Personal Scope

Parties to agreements on financial collateral arrangements are listed in article 1(2). These parties are; specific financial institutions, namely public sector debt and account management bodies, central banks, multilateral

[2] Source:Repo market surveys of International Capital Market Association(ICMA)(http://www.icma-group.org/surveys/repo.html) last visited on 26 May 2006
[3] See www.wikipedia.org for the definition of "indirect holding systems"

development banks, international financial institutions, central counterparties, settlement agents and clearing houses.(Collateral Directive, article 1(2)(a)-(d)) An additional category is also stated in article 1(2)(e) as "persons other than natural persons, including unincorporated firms and partnerships may participate in such arrangements provided that the other party is an institution defined in above articles 1(2)(a) to (d)." However an opt-out clause is stated for Member States so that they may exclude this additional category. (Collateral Directive, article 1(3)) This opt-out clause is the result of the countries which are supporting the need for stable and efficient financial market. (Lober & Klima, 2006)

Implementation of the personal scope of the directive differs between Member States mainly because of this opt-out clause. It is remarkable that except for Austria, all the other Member States have not used a full opt-out clause somehow. Malta had also decided to exercise this opt-out clause when they first implement the directive on May 1 2004, however they revoked this clause after having consultations with the local financial services industry on the basis that the other persons (including unincorporated firms and partnerships) stated in article 1(2)(e) could not benefit from the advantages of directive such as remedy of appropriation.(Portanier, 2005) An extended implementation is made by Belgium that Belgium has included natural persons, however excepting the title transfer transactions from this extension.(Lober & Klima, 2006)

3.2.2. Material Scope

The Directive only covers the financial collaterals in the form of cash [4] or financial instruments [5] according to article 1(4). Two types of financial collateral arrangements are defined in article 2(1) (b) and 2(1) (c) and directive applies to both of them. First, one is "title transfer financial collateral arrangement" (Collateral Directive article 2(1) (b)) in which a collateral provider transfers full ownership of the collateral to the collateral taker (this also includes repurchase agreements). Second, one is "security financial collateral arrangement" (Collateral Directive article 2(1) (c)) where a collateral provider provides financial collateral by way of security to a collateral taker, but the full ownership of the financial collateral remains with the collateral provider when the security right is established.

Material scope of application also includes an opt-out clause stated in article 1(4)(b), that allows Member States to exclude from the financial collateral consisting of the collateral provider's own shares, shares in affiliated under takings (Within the meaning of seventh council Directive 83/349/EEC of 13 June 1983 on consolidated accounts) and shares in undertakings whose exclusive purpose is to own means of the production that are essential for the collateral provider's business or to own real property. Denmark seems to be the only Member State using this opt-out clause in full. Countries like Germany has exercised a partial opt-out clause in its implementation namely if the collateral giver is a corporate entity some limitations apply (Lober, 2005). On the other hand, Czech Republic, Sweden and France have extended the material scope of the application for also particular kinds of receivables like bank loans or claims. (Lober & Klima, 2006)

Article 1(5) states another issue of evidencing the collateral. According to this article, the" directive applies to financial collateral once it has been provided and if that provision can be evidenced in writing". The Directive will govern the financial collateral arrangements, if it is evidenced in writing or in a legally equivalent manner (Collateral Directive, article 1(5) last sentence). What has to be understood from "writing" according to this directive is that writing also includes recording by electronic means and any other durable medium (Collateral Directive, article 2(3)).

3.3. Formal Requirements

Divergent formal requirements by Member States concerning collateral arrangements have hampered the harmonization of internal financial market. Laws which lay down a special procedure (for instance use of a defined stock transfer form) for transfer of securities do not vanish simply because the transfer constitutes a part of a financial collateral arrangement. (Turing &Lester, 2005) To overcome such procedures, thus limiting the administrative burdens for parties, the directive opted to minimize formal requirements in order to secure mutual recognition by Member States of the validity of such arrangements. (Asgeirsson, 2003/4) Formal requirements are

[4] According to the Collatarel Directive article 2(1)(d), "cash means money credited to an account in any currency, or similar claims for the repayment of money cush as money market deposits"

[5] According to the Collatarel Directive article 2(1)(e) " financial instruments means shares in companies and other securities equivalent to shares in companies and bonds and other forms of debt instruments, if these are negotiable on the capital market, and any other securities which are normally dealt in and which give the right to acquire to any sucs shares, bonds or any other securities by subscription, purchase or Exchange or which give rise to a cash settlement, including units in collective investment undertakings, money market instruments and claims relating to or rights in respect of any for going"

enacted under article 3 of directive. According to article 3(1), Member States shall not require formal requirements for creation, validity, perfection or enforceability of a financial collateral arrangement (such as notarial deeds, registration requirements, notification requirements, public announcements or other formal certifications (Lober & Klima, 2006)). However, Member States shall require conclusiveness of financial collateral arrangements in writing or in a legally equivalent manner. (Collateral Directive article 3(2))

3.4. Enforcement

Article 4 which regulates the enforcement of financial collateral arrangements provides improved enforcement rights. Collateral taker shall realise security collateral arrangements by sale or appropriation of the financial instruments and by setting of their value against, or applying their value in discharge of the relevant financial obligations (Collateral Directive article 4(1) (a)). When it comes to cash collateral, collateral taker shall realise by setting of the amount against or applying it in discharge of the relevant financial obligations (Collateral Directive article 4(1) (b)). However these procedures of realisation are only possible only if these are agreed by the parties in the security financial collateral arrangement (Collateral Directive article 4(1)). When they are then accepted in the collateral arrangement, Member States have to recognize those procedures without prior notice of the intention to realise, its approval by any court (public officer or other person), public auction or waiting period(Collateral Directive article 4(4)).

The Directive allows appropriation if parties agreed on the appropriation and on the valuation of the financial instruments in the security financial collateral arrangement (Collateral Directive article 4(2)). Appropriation was a new procedure for some jurisdictions of realising the collateral, in which the collateral taker may keep assets as their own property instead of selling collateral while setting off the value of collateral against their own relevant financial obligations against the collateral giver. (Lober & Klima, 2006)Appropriation is preferable to a sale where immense mass of a particular kind of financial instruments are involved. The reliability of this method depends on the fair valuation of the collateral at the time of the appropriation; therefore the interests of the collateral giver have to be protected. (Lober & Klima, 2006) This protection of the collateral giver is provided by the above mentioned clause of the directive (Collateral Directive article 4(2) (a)) that the appropriation is only possible only if parties agreed it in the collateral arrangement.

Article 4(3) of the directive states an opt-out clause for the appropriation procedure. Member States which did not allow appropriation on 27 June 2002 were not obliged to recognize it. However, all the 25 Member States recognize appropriation and implemented it into their legislations. (Lober & Klima, 2006)

The enforcement of collateral arrangements is protected from effects of reorganization measures and winding-up proceedings with the article 4(5) of the directive: “Member States shall ensure that a financial collateral arrangement can take effect in accordance with it terms notwithstanding the commencement or the continuation of winding-up proceedings or reorganization measures in respect of the collateral provider or collateral taker”.

These provisions (articles 4, 5, 6 and 7 of the Collateral Directive) shall not prejudice any requirements under national law. Hence, realisation or valuation of financial collateral and the calculation of relevant financial obligations must be conducted in a commercially reasonable way. (Collateral Directive article 4(6)) However one of the commentators has mentioned that the satisfaction of this reasonableness test is questionable as what have to be understood from the wording “reasonable” is not lucid (for details of the implementation of the Collateral Directive in Italy Lantalme, 2004).

3.5. Right of Use of Financial Collateral

According to article 5 of the Collateral Directive, a right of use [6] collateral should be available if and to the extent that the terms of a security financial arrangement so provide. In other words, it seems that the right of use collateral subject to a condition under directive. However, in UK implementation, the right of use is not attached to a condition. (Mccormack, 2003)

If a collateral taker exercises a right of use, certain obligations are imposed on that party, namely to replace the original financial collateral with equivalent financial collateral or, if the arrangement permits to set off the financial collateral against the relevant financial obligations. (Collateral Directive article 5(2)) The equivalent financial collateral shall be subject to the same terms of the arrangements as the original financial collateral was subject to under the article 5(3) of the directive. In addition to this, Member States shall ensure that the use of financial collateral by the collateral taker under a financial collateral arrangement does not render the rights of the

[6] According to the Collatarel Directive article 2(1)(m), “right of use means the right of the collateral taker to use and dispose of financial collateral provided under a security financial collateral arrangement as the owner of it in accordance with the terms of the security financial collateral arrangements”.

collateral taker invalid or unenforceable. (Collateral Directive article 5(4))If an enforcement event occurs, while assets are in the process of reuse, then the obligations of the collateral taker may be brought into account in a close-out netting arrangement. (Collateral Directive article 5(5))

Contrary to the appropriation procedure, no opt-out provision was supplied for the right of use. As a result of this, almost all Member States have implemented the right of use technique into their national legislations. German implementation of the directive does not contain a particular provision for this technique as they have had it in their customary law before the directive. (Lober & Klima, 2006)

3.6. Title Transfer

Member States must ensure that a title transfer financial collateral arrangement can take effect in accordance with its terms according to article 6(1) of the directive. In other words the risk of being re-characterised as a security financial collateral arrangement for title transfer financial collaterals' is abolished.[7] Thus, repurchase agreements which are the best known form of title transfer collateral arrangements benefit from the same legal protection that is provided for security financial collateral arrangements that will facilitate the use of repurchase agreements by reducing the uncertainty about their performance. This is why this provision has a basic importance for institutions (for instance central banks) that engage in such transactions. (Asgeirsson, 2003/4)

Article 6(2) states that, if collateral falls to be enforced while any obligation of the collateral taker to transfer equivalent collateral remains outstanding, the obligation may be subject of a close-out netting provision.

3.7. Close-out Netting

The enforceability of the close-out netting arrangements is explicitly protected notwithstanding the insolvency of the parties to the relevant collateral arrangement. (For details, see recital 14 of the Collateral Directive that mentions the importance of protecting the enforcement of the bilateral close-out netting.) . Hence, under article 7 of the Directive, Member states shall ensure that a close-out netting provision can take effect in accordance with its terms, notwithstanding winding-up proceedings or reorganization measures in respect of the collateral provider and/or collateral taker. The Directive does not permit the attachment of a contractual right, for example, a third party creditor or competent court that may prejudice the effectiveness of the close-out netting. (Collateral Directive article 7(1) (b))

The comparison of Settlement Finality Directive and Collateral Directive is made on the close-out netting provisions that have to be taken into account. (Westerlund, 2004) Both of the directives overlap only to a specific extent. Oppose to the Settlement Finality Directive that only applies to obligations arising from securities and currency trading, Collateral Directive applies to all types of obligations. Settlement Finality Directive allows netting between multiple parties where as the Collateral Directive merely applies to netting between two parties (collateral provider and collateral taker). The commentator of this comparative analysis added that implementation of these directives raises the effectiveness of contractual close-out nettings. (Westerlund, 2004)

Close-out netting provisions can operate without being subject to the requirements stated in article 4(4) namely prior notice, approval from courts and public auction. (Collateral Directive article 7(2))

3.8. Insolvency Issues

Member states are blocked by article 8 of the Collateral Directive, which operates as an escape clause, from applying their national insolvency rules to financial collateral arrangements.(G. Gungor, 2005) The reason for this blocking is to improve the legal certainty of financial collateral arrangements and fostering a cost-effective internal financial market as applying national laws will hamper the effective realisation of financial collateral or cast doubt on the validity of current techniques like, bilateral close-out netting, top-up collateral and substitution of collateral. (Collateral Directive, recital 5)

The Collateral Directive rejects the retrospective effect of winding-up proceedings and reorganisation measures regarding to collateral arrangements by enacting article 8(1). (Sharp, 2004) Rejecting the retrospective effect can also be deemed as abolishing the zero-hour rule. According to article 8(1), financial collateral arrangements may not be declared invalid or void on the sole basis that the arrangement or obligations came into existence on the day of the commencement of winding-up proceedings or reorganisation measures or in a prescribed period prior to the commencement of such proceedings or measures.

[7] UK courts have also rejected the recharacterising such agreements as security financial collateral arrangements. Hence, UK law already fulfils the requirements of this provision of the directive. See "Implementing the Financial Collateral Arrangements Directive 2002/47/EC – A Transposition Note" (http://www.hm-treasury.gov.uk/)

Financial collateral arrangements are enforceable and binding on third parties, if the collateral arrangement or a relevant financial obligation has come into existence on the day of, but after the moment of commencement of winding-up proceedings or reorganisation measures, provided that the collateral taker can show that he was not aware or should not have been aware of such proceedings or measures. In addition to this if the financial collateral is provided on the same day but after the commencement of such proceedings and measures, such arrangements shall also be binding. (Collateral Directive article 8(2))

Questioning the provision of top-up and substitution financial collateral arrangement on the sole basis that the relevant financial obligations existed before that financial collateral was provided or that the financial collateral was provided during a prescribed period is prevented by the wording of article 8(3). However the potentiality of questioning the top-up and substitution collateral under national laws is not completely rejected on the basis of misuse, for instance top-up or substitution can be done intentionally to the detriment of the other creditors. (Collateral Directive recital 16) If a financial arrangement contains an obligation of top-up collateral or provisions for a right of substitution of the collateral; then the obligation or right shall not be treated invalid or reversed on the sole basis that the financial collateral was provided on the same day at when the winding-up proceedings or reorganisation measures commenced or that the relevant financial obligations were incurred prior to the date of the provision of the collateral. (Collateral Directive article 8(3))

There seems to be a conflict in the directive between articles 4(5) and 8(4), in article 4(5) the enforcement of collateral arrangements is protected from effects of reorganisation measures and winding-up proceedings, where as in article 8(4) the general rules of the national insolvency law is left unaffected regarding to the voidance of transactions entered into during the prescribed period referred to in paragraph 1(d) and 3(i) of article 8. Therefore, it can be understood from the wording of article 8(4) that the national laws of the Member States handling the avoidance of transactions entered into during the suspect period does not want to be ameliorated by the directive (G. Gungor, 2005)). So, questioning the issues such as the top-up and substitution collateral under national laws is possible as it is mentioned at the previous paragraph.

3.9. Conflict of Laws

3.9.1. Complexity of the Book-Entry Security Collateral Arrangements - Point of Conflict of Laws View

Since it is written under the title of "necessity for a harmonized collateral law", it is very vital to ascertain which law will apply to collateral arrangements. Suppose that, an individual investor pledges the securities which are credited to his deposit account with his bank to that bank. Bank can also pledge the same securities to its own creditors or to a clearing institution in which an immense amount of these securities are being held. In this kind of a situation the parties claim regarding their rights in those securities may conflict with each other. What is more, if transferred or pledged securities represented by a global instrument and/or dematerialized and holding by a custodian in a global custody, then the situation becomes very sophisticated. (Einhorn & Siehr (eds), 2004) Hence a movement from direct holding systems to indirect holding system can be seen very clearly in recent times and this tendency threatens the certainty as to the law applicable in cross-border securities transactions. The main problem in indirect holding system is to localize the arrangement because the ownership and other proprietary rights in an indirect holding system may be held and transferred thorough several different countries as the participants of indirect holding system are generally located in different states. As a consequence, the number of national laws applicable to the situation will increase and this will shake the legal certainty of the market. (G. Gungor, 2005)

The law governing collateral security is the law of the country where the underlying financial is located under the "*lex rei sitae"* principle. However, determining the location is a very tremendous task especially in collateral arrangements consists of book-entry securities. Book-entry securities are dematerialized securities that have no physical existence and only exist as an entry on a securities account (Vereecken & Kierszenbaum, 2005). A clear definition of *"book-entry security collateral which is the indirectly held security that is taken by the creditor in financial market transactions to be enforced on the intangible collateral on default(of payment or any other relevant obligation) by debtor"* is made by G. G. Gungor.

The holding of book-entry securities "indirectly" means that, they are held on an account with an intermediary, not with an ultimate owner. Such securities will be held in turn with that intermediary and national central securities depository that may also in turn hold these same securities with an international central securities depository like Euroclear. (Vereecken & Kierszenbaum, 2005) This is why determining the location of such securities is a very tremendous task, as those securities are held by many tiers of intermediaries. The doctrine asserted that, the only common localization place can be the place of the relevant intermediary in which the existence of interest on the books of that relevant intermediary is proved. (G.Gungor, 2005) This approach seems very rational on the basis that a pool of securities of the same issue on behalf of the investor and other investors is held by an intermediary and no specific securities are distinguishable as belonging to any investor. What is more, the pools over the accounts with one or more sub-intermediaries are likewise held by intermediaries. Hence, doctrine's assertion on the place of the relevant intermediary constitutes a common centre point regarding to the rights of the all interested parties. (G.Gungor, 2005)

3.9.2 PRIMA Principle

Before analyzing the conflict of laws provisions of the Collateral Directive, them PRIMA (Place of the Relevant Intermediary) principle has to be explained. PRIMA can be deemed as a principle of conflict of laws that apply to the security transactions with respect to their proprietary aspects which also constitutes the basis for Hague Securities Convention. [8] One of the biggest advantages of PRIMA principle is that, it subjects an investor's interest in securities to the law of a single jurisdiction (in other words localize to a one single place), even where evidence of securities is situated in several different countries which maintains certainty and clarity for all parties involved.[9]

There was almost unanimity on the acceptance of the PRIMA rule at the conferences of the Special Commission on the discussions of the Hague Securities Convention Draft that this should be the relevant connecting factor for ascertaining the applicable law to dispositions and security in securities that are held indirectly by intermediaries. (Einhorn & Siehr (eds), 2004) Although the acceptance of the PRIMA rule was very quick, defining the place of the relevant intermediary was much more difficult and controversial. After debates, it was accepted that the law applicable would be the law of that state in which securities account is maintained subject to the agreement between the investor and the relevant intermediary if only the relevant intermediary has an office or an equivalent activity there at the time of the agreement. (Hague Securities Convention, article 4)

3.9.3 Conflict of Laws Provisions in Collateral Directive

The Settlement Finality Directive also stated a conflict of laws provision concerning book-entry securities only if that security interest was vested in favour of certain categories of parties. According to the Settlement Finality Directive, the law of the Member State in which such securities are legally recorded on a register, account or centralised deposit system will be the governing law. (Finality Settlement Directive article, 9(2))The Collateral Directive extends the rule stated in Settlement Finality Directive to financial collateral arrangements including book-entry securities provided as collateral in a cross-border context. Article 9(1) of the Collateral Directive states that any question regarding to specified matters in relation to book entry securities collateral shall be governed by the law of the country in which the relevant account is maintained. "Relevant account" is defined as a register or an account – which may be maintained by the collateral taker - in which the entries are made by which that book-entry securities collateral is provided to the collateral taker in article 2(1) (h) of the Collateral Directive.

Although both the Settlement Finality and Collateral Directive with respect to conflict of laws provisions do not overlap with the Hague Securities Convention in letter, it can be accepted that both directive overlaps with the Hague Securities Convention in spirit. Thus, article 9(1) of the Collateral Directive has to be understood in a sense that is in accordance with the PRIMA principle like; the applicable law shall be the law of the country in which the relevant intermediary has its office that provides the relevant account.

Renvoi is expressly rejected, as the reference to the law of the country is a reference to the domestic law of that country. (Collateral Directive, article 9(1)) This seems to be an appropriate provision as the localization issue would become insoluble if *renvoi* was accepted.

The law of the country in which the relevant account is maintained will govern legal matters which are listed in article 9(2) of the Collateral Directive. These are;

- the legal nature and proprietary effects of the book-entry securities collateral(Collateral Directive, article 9(2)(a));
- the perfection requirements of a financial collateral arrangement with respect to the book entry securities collateral and of the provision of book entry securities collateral under such arrangement and usually the completion of the steps essential to render such an arrangement and provision effective against third parties(Collateral Directive, article 9(2)(b));
- whether a title or interest book-entry securities collateral is overridden by or subordinated by a competing title or interest or whether a good faith acquisition has occurred (Collateral Directive, article 9(2)(c));
- requirements for the realisation of the book-entry securities collateral following the occurrence of an enforcement event (Collateral Directive, article 9(2) (d)).

[8] Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary, signed at the Hague on December 15, 2002(http://www.hcch.net/index_en.php?act=conventions.text&cid=72) hereafter cited as Hague Securities Convention

[9] See for details, http://en.wikipedia.org/wiki/Place_of_the_Relevant_Intermediary_Approach

3.9.4. Effect of the Divergent Implementations of Collateral Directive to Conflict of Laws

While explaining the personal scope of the Collateral Directive, it is mentioned that there is an opt-out clause (Collateral Directive, article 1(2) (e)) for Member States. In addition to this, different implementations from different Member States have also been given to illustrate the situation which shows that is a divergence of implementations through the EU.

Member States may extend the personal scope of the directive by not enacting the opt-out clause into their national laws. For an illustration, United Kingdom has extended the scope of the directive by not enacting the opt-out clause to other legal entities, where only one party falls within one of the categories listed in article 1(2) (a) to 1(2) (d) and where as the majority of Member States have limited the scope of the directive by enacting opt-out clause. (Fawcett, 2005) Suppose that the parties to a collateral arrangement involve a partnership that is subject to the opt-out clause and a central bank. According to the UK implementation of the directive this arrangement will fall under the scope of the directive, whereas it will not to Austria on the basis that enacting the opt-out clause in full. As the office of the relevant intermediary is located in Austria, according to article 9(1) of the directive, the applicable law will be the Austrian law (from the viewpoint of UK). However, when this legal matter goes to Austria, Austrians may reject to solve this issue under Collateral Directive as this arrangement does not fall under the Collateral Directive from the view of Austrian implementation. What will be done in such a situation is a question that has no answer yet. One has to bear in mind that the rise of these kinds of situations may threaten the stability and certainty of the financial markets.

4. CONCLUSION

Collateralisation which can be deemed as a primary risk mitigation technique is becoming a very vital instrument for the modern financial markets as it is used nearly in all types of transactions. The necessity for a uniform set of rules in financial markets triggered the practitioners and jurists, as a result of this, Settlement Finality, Reorganisation and Winding up of Credit Institutions and Collateral Directives were enacted.

Removing certain obstacles to the efficient use of collateral arrangements by limiting the formalities for the creation or enforcement of the financial collaterals, supporting the protection of collateral arrangements from insolvency and reorganization rules, recognizing the title transfer of the collateral arrangements and close-out netting structures, allowing the right of reuse, to enlighten the issue of the applicable law to book-entry securities collateral by stating that the governing law shall be the law of the country where the securities account is maintained are the main objectives of the Collateral Directive.

The deficiencies of the Collateral Directive have also been taken into account, like the different implementations of the directive in Member States by enacting opt-out clauses, allowing appropriation if only parties have agreed on it, or to leave the door open to Member States so that they can hamper the certainty of financial markets by applying their national laws. (Collateral Directive article 4(6))

Consequently, it seems that the collateral directive will contribute to the stability and cost-efficiency of financial market, so that the free movement of capital in the single market will be provided. Although the Collateral Directive involves some deficiencies in itself, these can not cast a shadow on the success of the directive.

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