



EUROPEAN CENTRAL BANK

OPINION OF THE EUROPEAN CENTRAL BANK

of 16 February 2006

at the request of Lietuvos bankas

on a draft law amending the Law on settlement finality in payment and securities settlement systems

(CON/2006/5)

On 16 November 2005 the European Central Bank (ECB) received a request from Lietuvos bankas for an opinion on a draft law amending the Law on settlement finality in payment and securities settlement systems (hereinafter the 'draft law').

The ECB's competence to deliver an opinion is based on the fifth indent of Article 2(1) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions¹, as the draft law relates to payment and settlement systems. Although national authorities are not obliged to consult the ECB on draft legislation transposing Community directives into national law, under Article 25 of the Statute the ECB may offer advice to and be consulted by the competent authorities of the Member States on the scope and implementation of Community legislation relating to the stability of the financial system. This legislation includes Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems² (hereinafter the 'Settlement Finality Directive'). In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

1 General remarks

1.1 The ECB understands that the main objective of the draft law is to extend the scope of the Law on settlement finality in payment and securities settlement systems (hereinafter the 'SFD Law') in order to ensure that bankruptcy and/or suspension of operations of an institution registered in Lithuania do not affect the operation and soundness of a payment or securities settlement system governed by the law of a Member State other than Lithuania. The ECB welcomes the initiative of Lietuvos bankas in addressing this issue, since it is interested in promoting a harmonised EU-wide implementation of the Settlement Finality Directive in Member States, in order to ensure legal

¹ OJ L 189, 3.7.1998, p. 42.

² OJ L 166, 11.6.1998, p. 45.

certainty for payment and securities settlement systems and a level playing field throughout the Community.

- 1.2 As a preliminary remark, the ECB suggests that the SFD Law should refer to ‘systems’ in general terms rather than to specific types of systems, to reflect the fact that it aims to protect as wide a range of systems as possible and to minimise systemic risk. More detailed comments regarding this issue are set out in paragraph 2.2.1 of this opinion.

2 Definitions

2.1 *Insolvency proceedings*

The ECB notes that Article 2(13) of the SFD Law defines the suspension of operations as a ‘decision by a court or other authorised institution of the Republic of Lithuania or a Member State relating to the prohibition on a system participant disposing of funds or securities held in a settlement account or the application of temporary judicial protective measures or enforcement measures by the supervisory authority to a system participant resulting in the suspension or limitation of securities transfer orders and/or payment instructions’. The ECB understands that this definition would capture most of the measures resulting in the suspension or limitation of securities transfer orders and/or payment instructions and would be in line with the Settlement Finality Directive. However, Lietuvos bankas may consider using this opportunity to go beyond the minimum scope of protection provided in the Settlement Finality Directive and to expressly provide in the draft law that voluntary winding-ups are also covered by the SFD Law.

2.2 *Systems protected by the SFD Law*

- 2.2.1 Article 2(17) of the SFD Law, including the proposed amendments set out in the draft law, limits the definition of systems protected by the SFD Law to payment and securities settlement systems. Although not strictly required by the Settlement Finality Directive, Lietuvos bankas may consider referring to ‘systems’ in the SFD Law in more general terms, i.e. without specifying various types of existing or future systems³. In some instances, Member States may see the need to designate a clearing system⁴.

- 2.2.2 Article 1 of the draft law amends the definition of ‘system’ and provides, *inter alia*, that Lithuanian law may be chosen as the law governing a system if at least one of the system’s participants has its head office in Lithuania. Article 2(17) of the existing SFD Law only refers to an ‘office’ (*buveinė*) of a participant in Lithuania. The new wording to be introduced by the draft law is welcome since it more appropriately reflects the wording of the Settlement Finality Directive, which requires that the participants may only choose the law of a Member State in which at least one of them has its ‘head office’.

³ See the definition of ‘system’ in Article 2(a) of the Settlement Finality Directive.

⁴ See the current list of designated and notified systems at http://www.europa.eu.int/comm/internal_market/financial-markets/settlement/dir-98-26-art10-national_en.htm

2.3 *Institutions*

Article 1 of the draft law proposes to include, in the definition of an ‘institution’, legal entities which provide funds transfer services. The ECB notes that Article 2(f) of the Settlement Finality Directive defines a participant as ‘an institution, a central counterparty, a settlement agent or a clearing house’. Moreover, Article 2(b) of the Directive refers to undertakings which can be regarded as institutions, including undertakings which participate in a supervised system executing securities transfers and payments resulting from such orders. The ECB therefore notes that Article 1 of the draft law may be considered as going beyond the provisions of the Settlement Finality Directive and therefore suggests aligning the draft law with Article 2(b) of the Directive.

2.4 *Securities*

The ECB notes that the SFD Law defines ‘securities’ by reference to the Law on the securities market. It is also noted that Article 2(h) of the Settlement Finality Directive defines ‘securities’ as all instruments referred to in Section B of the Annex to the Investment Services Directive⁵. The Investment Services Directive will be repealed by the Markets in Financial Instruments Directive⁶, with effect from 30 April 2006. If the current proposal regarding the deadlines for transposition and application of the Markets in Financial Instruments Directive is adopted, this date will be postponed⁷. Under Article 69 of the Markets in Financial Instruments Directive, references to terms defined in the Investment Services Directive will henceforth have to be construed as references to equivalent terms defined in the Markets in Financial Instruments Directive. Section C of Annex I to the Markets in Financial Instruments Directive contains a more detailed list of financial instruments than Section B of the Annex to the Investment Services Directive. The ECB therefore draws Lietuvos bankas’s attention to the fact that the reference to the definition of securities in the SFD Law will have to be reviewed in the light of the Markets in Financial Instruments Directive.

3 Law governing the rights and obligations of a participant

Article 4 of the draft law expressly states that in the event that operations are suspended against a participant in a system governed by the law of another Member State, the law of that Member State governs the participant’s rights and obligations arising from participation in that system. This provision remedies the situation under the existing SFD Law whereby only bankruptcy proceedings are mentioned with respect to participation in a system governed by law of another Member State. The ECB welcomes this amendment.

⁵ Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field (OJ L 141, 11.6.1993, p. 27).

⁶ Article 69 of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (OJ L 145, 30.4.2004, p. 1).

⁷ See Commission of the European Communities, ‘Proposal for a Directive of the European Parliament and of the Council amending Directive 2004/39/EC on markets in financial instruments, as regards certain deadlines’ (COM(2005) 253 final, 14.6.2005).

4 No unwinding of netting or revocation of transfer orders

- 4.1 Under Article 3(2) of the Settlement Finality Directive, actions relating to underlying transactions may in no way lead to the ‘unwinding of netting’. Furthermore, recital 13 to the Settlement Finality Directive states that, for example, in the event of fraud or technical error, the Directive does not prevent a participant or a third party from exercising any right or claim resulting from the underlying transaction as long as this leads ‘neither to the unwinding of netting nor to the revocation of the transfer order in the system’. In a number of Member States, the laws implementing the Settlement Finality Directive expressly confirm that although the underlying transaction could potentially be challenged in the context of proceedings such as the avoidance of transactions, this would only have an impact on the bilateral relationship between the payer and the payee, not on the system.
- 4.2 Article 7(5) of the SFD Law states that netting may not be unwound if a transaction concluded before the initiation of bankruptcy proceedings is recognised as void on the grounds defined by the laws regulating the bankruptcy of a system participant. The ECB notes that transactions may also be declared void not only under the laws regulating the bankruptcy of a system participant, but also under other Lithuanian laws, such as the Law on enterprise restructuring or the Civil Code (which refers to *actio Pauliana*). In addition, transfer orders, including payment orders, should also not be subject to revocation. The ECB suggests clarifying in the SFD Law that, if an underlying transaction is void: (i) netting may not be unwound; (ii) transfer orders, including payment orders, may not be revoked; and (iii) this would only affect the bilateral relationship between the payer and the payee, not the system.

5 Bankruptcy and restructuring laws

- 5.1 As already mentioned, Article 7 of the Settlement Finality Directive prohibits any insolvency proceedings initiated against a participant from having retroactive effect on the rights and obligations of the participants in a system. The prerogatives in insolvency proceedings of courts, liquidators, administrators and other officials, such as the power to limit the disposition of an insolvent participant’s property, must therefore be limited in order to ensure the enforceability of transfer orders and netting in the system.
- 5.2 The ECB notes that certain Lithuanian laws, such as the Law on enterprise bankruptcy and the Law on enterprise restructuring, impose certain restrictions on the disposition of an insolvent entity’s property and entitle the administrators to terminate contracts entered into before proceedings are initiated. The ECB notes that the Law on enterprise bankruptcy and the Law on enterprise restructuring are generally regarded as taking priority over other laws. Although the Law on enterprise bankruptcy already provides for exemptions from some of its provisions in cases covered by the SFD Law, the ECB recommends inserting a general provision in both the Law on enterprise

bankruptcy and the Law on enterprise restructuring providing that the SFD Law takes priority as far as rights and obligations arising from participation in a system are concerned.

This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 16 February 2006.

[signed]

The President of the ECB

Jean-Claude TRICHET