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The concept of financial institutions in financial collateral arrangements

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Pursuant to European Union law, the concept of financial institutions under Royal Decree-Law 5/2005 must be extended to include other institutions not expressly provided for in the same.

1. Introduction

In the following lines, we will try to expound how financial collateral arrangements can be concluded by financial institutions that are not expressly mentioned in Royal Decree-Law 5/2005, of 11 March, on urgent reforms to boost productivity and improve public procurement, Part II of Title I (Arts. 2 to 17) whereof has the heading "On contractual netting agreements and financial collateral arrangements". Royal Decree-Law 5/2005 was passed prior to the financial crisis of 2008 and makes necessary the incorporation into our law of Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements. The 2005 legislator could not foresee the impact of shadow banking on systemic risk, which led to the adoption of Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and, subsequently, Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse, with the aim of increasing transparency in the operations of, inter alia, hedge funds and private equity.

Although three articles of Royal Decree-Law 5/2005 were amended in 2015, such amendments were due to the necessary transposition of Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms (which amended the Directive on financial collateral arrangements), transposed by the Credit Institutions and Investment Firms (Recovery and Resolution) Act 11/2015 of 18 June, whose seventh additional provision amends Articles 2, 4 and 5 of Royal Decree-Law 5/2005. However, no account was taken of the fact that other European legislation subsequent to the 2002 Directive on financial collateral arrangements also affects the rules governing these arrangements as regards what institutions may conclude them and therefore be subject to the rules of Part II of Royal Decree-Law 5/2005. This is yet another manifestation of a legislative method where the Spanish legislator limits himself to transferring one by one to our legal system the content of pieces of legislation adopted by the EU, from royal decree-law to royal decree-law, each time a directive or a regulation must be incorporated, without taking into account other European rules impinging, in our case, on financial collateral arrangements.

2. The concept of financial institutions under Royal Decree-Law 5/2005 and hedge funds

For the application of the rules on financial collateral arrangements established in Royal Decree-Law 5/2005, one of the parties to the arrangement must have, for our purposes, the status of financial institution as referred to in Article 4(1)(c) of Royal Decree Law 5/2005: "c) Credit institutions; investment firms; insurance undertakings; schemes for collective investment in transferable securities and their managers; mortgage securitisation funds, asset securitisation funds and securitisation fund managers; pension funds, and other financial institutions, as defined in Article 4(5) of Directive 2006/48 of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions".

The question arises with respect to institutions, either traditionally attached to shadow banking - which do not have the status of collective investment schemes, insurance undertakings, mortgage securitisation funds, asset securitisation funds and securitisation fund managers and pension funds, expressly mentioned in Article 4 delimiting the subjective scope of financial collateral arrangements for the purposes of Royal Decree-Law 5/2005 - or included in the residual clause of Article 4(1)(c) of Royal Decree-Law: "other financial institutions, as defined in Article 4(5) of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions".

Financial institutions as defined in Article 4(5) of the repealed Directive 2006/48 are undertakings, other than a credit institution, the principal activity of which is to acquire holdings or to carry on one or more of the activities listed in points 2 to 12 of Annex I thereto. Annex I to Directive 2006/48 contains the list of typical activities of credit institutions, financial credit establishments and investment firms, which are traditionally grouped into banking, investment services and payment services and are subject to mutual recognition ("European passport"). This directive was repealed by Directive 2013/36/EU of the European Parliament and of the Council of 26 June on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, and today the list can be found in Annex I of Directive 2013/26/EU, Annex I that retains the content of the previous one, except for the inclusion of certain clarifications (e.g. the reference to credit agreements relating to immovable property as part of lending activities, or the detail when referring to the provision of payment services, or the reference to advice as part of portfolio management).

a) *Free Collective Investment Institutions*

With regard to the reference to "schemes for collective investment in transferable securities and their managers" (Art. 4(1) RDL 5/2005), we believe that free collective investment schemes (IICILs) should be included in this concept, which, from an economic point of view, are included in the concept of hedge funds or *alternative investment funds*. This is so for several reasons: firstly, because Article 4 on the personal elements of financial collateral arrangements does not expressly refer to the harmonised status of collective investment schemes, i.e. to their being subsumed in Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS). And, thus, *ubi lex non distinguit, nec nos distinguere debemus*. The reference in Royal Decree-Law 5/2005 to the concept of financial institutions is, for all intents and purposes, to "schemes for collective investment in transferable securities and their managers", which covers both traditional or harmonised collective investment undertakings under Directive 2009/65/EC and free collective investment schemes or non-harmonised collective investment undertakings (hedge funds), recognised in our law for the first time with the amendment to the Collective Investment Schemes Act of 2014 (Arts. 33 *bis* and 33 *ter* there of) for the necessary adaptation to the Directive on Alternative Investment Fund Managers, which, in a parallel process with the United States, regulates the managers of *alternative investment funds*, including free collective investment schemes (IICILs). And, secondly, because, if the previous argument is not accepted, free collective investment schemes can always be considered hedge funds or alternative investment funds, a matter referred to in the following section.

b) *Other alternative investment financial institutions (hedge funds and private equity)*

That being said, what matters now is to delimit the broader concept of alternative investment fund under Directive 2011/61/EU, which includes other institutions in addition to free collective investment schemes.

In order to resolve this matter, which is of great practical importance given that other institutions not mentioned in Article 4 of Royal Decree-Law 5/2005 could conclude financial collateral arrangements under the Royal Decree-Law, we must bring up the aforementioned Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse. This regulation applies to financial collateral arrangements and includes, among the institutions that can conclude them, alternative investment fund managers, in addition to the institutions already mentioned in the preceding pages.

Article 4(1) of Directive 2011/61/EU defines alternative investment funds as "collective investment undertakings, including investment compartments thereof, which: (i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and (ii) do not require authorisation pursuant to Article 5 of Directive 2009/65/EC."

We should not be misled by the Spanish translation of Article 4(1) with regard to the concept of 'alternative investment fund' (which is not the direct subject matter of this directive, neutral with regard to the legal form adopted by the institutions with and without legal personality subject to management), in the sense that we have to understand alternative investment funds, and only these, as non-harmonised collective investment schemes. If we read the recitals of the English version, we see that there is a reference, in terminology commonly accepted by financial operators, to private equity, venture capital funds and real estate funds (see Recitals 34 and 78 of the directive), expressions which have been translated into Spanish in the Spanish version of Directive 2011/61/EU as "*fondos de capital inversión, fondos de capital de riesgo y fondos inmobiliarios*", or as "*fondos de capital riesgo/inversión y capital/riesgo*" when the English version refers to *equity and venture capital funds* (Art. 69). The Alternative Investment Fund Managers Directive was one of the European legislator's responses to the economic crisis of 2008, when the role of hedge funds and private equity as a transmission belt for systemic risk in the securities and credit markets became clear. The 2011 directive imposes an obligation to register these institutions with the national supervisor and also lays down certain reporting obligations to allow for the assessment of the risk that hedge funds and private equity effectively pose for financial stability. The Spanish legislator incorporates its content by means of Act 22/2014, of 12 November, regulating private investment (venture capital/private equity) entities, collective investment firms of a closed-ended type and their managers, and amending the Collective Investment Schemes Act 35/2003 of 4 November.

In addition, in support of our view, we must bring up the aforementioned Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse, which includes within its objective scope (*ratione materiae*) financial collateral arrangements - as defined in Article 2 of Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements - concluded between counterparties to secure any obligation (see Article 3(13), (14) and (15) of the Securities Financing Transactions Regulation). The delimitation of the subjective scope (*ratione personae*) of application of this regulation - and, therefore, of the institutions that conclude or may conclude financial collateral arrangements - can be found in Article 3, titled “Definitions”. The financial counterparties, subject, inter alia, to the obligation to report on securities financing transactions to a trade repository (Art. 4) registered with the European Securities and Markets Authority (Art. 5) include investment firms (Directive 2014/65/EU), credit institutions (Directive 2013/36/EU), insurance and reinsurance undertakings (Directive 2009/138/EC), undertakings for collective investment in transferable securities (Directive 2009/65/EC), alternative investment funds (Directive 2011/61/EU), pension funds (Directive 2003/41/EC), central counterparties (Regulation (EU) 648/2012), central securities depositories (Regulation (EU) 909/2014) and third-country institutions that require authorisation or registration in accordance with their legal status because they belong to one of the above categories, if they are established in the European Union.

Therefore, the concept of financial institutions for the purposes of financial collateral arrangements regulated by Royal Decree-Law 5/2005 must include all entities mentioned in the previous paragraph. This piece of legislation should be interpreted in accordance with European legislation subsequent to its adoption. The aforementioned entities are all subject to administrative authorisation and prudential supervision - to a greater or lesser degree, depending on their systemic importance -, be it of the Bank of Spain, the Spanish Securities Market Authority or the Spanish Directorate-General for Insurance and Pension Funds.

Furthermore, it would not make sense for a national law (Royal Decree-Law 5/2005) to limit the scope of a European Union regulation (the Securities Financing Transactions Regulation) that expressly includes financial collateral arrangements in its objective scope and, within the subjective scope, all the aforementioned institutions. A regulation that, as indicated by the European Securities and Markets Authority, is part of a coordinated global effort to reduce the risks of financial instability that may result from shadow banking activity.

Finally, let us recall the preamble to Royal Decree-Law 5/2005 in section II: “Part II of Title I incorporates Directive 2002/47/EC of the European Parliament and of the Council of 6 June on financial collateral arrangements into Spanish law. The adoption of this directive is intended to achieve broad harmonisation across the EU for all financial collateral arrangements concluded by authorised parties, establishing certain limitations by determining that, on the one hand, one of the parties must be a financial institution, subject to public authorisation and supervision, and, on the other, its general application to legal persons”. In 2005, the managers of alternative investment funds did not always fall under our positive law. Not even private equity - at least in Spain - presented systemic risk. The 2008 crisis has led to the regulation and supervision of these shadow banking institutions, which represent, in assets, 40% of the European Union’s financial system (approximately forty-two trillion euros by the end of 2017; see European Systemic Risk Board, EU Shadow Banking Monitor, 3, 2018, p. 3).