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Memo

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Von	Gerd Stuhlmacher
Betreff	EU Insolvency Law Harmonization
Datum	6. Oktober 2023

DRAFT MEMO

EU Insolvency Law Harmonization;
Proposed Directive

1. Scope and background

Currently, with some limited exemptions, EU legislation does **not harmonize insolvency[1] law**, rather it is up to Member States to develop it as part of their national body of law.

This has now been identified by the EU as one of the key obstacles to the freedom of capital movement in the EU and to greater integration of the EU's capital markets. According to their assessment, insolvency rules are fragmented along national lines.[2] As a result, they deliver different outcomes across Member States, and in particular they have different degrees of efficiency in terms of the time it takes to liquidate a company and the value that can eventually be recovered. The ongoing energy crisis and the limited fiscal space for public subsidies may result in an increase in business exits in the future.

On top of that and from an **energy trading perspective**, the lack of harmonized insolvency laws does in particular negatively impact the efficiency of cross border trading transactions between trading counterparties domiciled in different jurisdictions. This is due to the fact that insolvency law applies on a mandatory basis and its application can just to a very limited extent be steered by choice of law clauses. Therefore, it has been EFETs traditional position

[1] The Proposed Directive does not define insolvency but refers to Directive (EU) 2019/1023 (available under the following link), whose Article 2 (2) establishes that the concept of insolvency is to be understood as defined by national law.
[2] According to a European Banking Authority study published in 2020 and available under the following link, the recovery time during insolvency proceedings ranges from 0.6 to 7 years on average across Member States. The (simple) average recovery rate of corporate loans in the EU was 40 % of the amount outstanding at the time of the default, but it varied between 6.9 % (Poland) and 95.2 % (Denmark). The average rate for SMEs was 34 % as of 2018.

to **support harmonization efforts**, provided however, the concrete content of the legislative initiatives meets the objectives of EFET and benefits energy trading.

Against this background, EFET has asked us to provide a summary and first analysis of the Proposed Directive[3], accompanied by amendments proposals where appropriate.

In that regard, we will put particular attention to the position of other associations including ISDA and take into account the current ISDA discussion paper[4], which outlines the key features of the Proposed Directive as they pertain to OTC derivatives business and puts forth suggestions for amendments to address potential concerns.

2. General content and context of the Proposed Directive

The Proposed Directive is based on Article 114 TFEU, which allows the adoption of measures for the approximation of national provisions with the objective to establish a functioning internal market.[5] The Proposal would complement two pieces of legislation, one the Directive (EU) 2019/1023[6] and two the Regulation (EU) 2015/848[7] aiming to close gaps in those previous EU legislations on insolvency rules.

[3] Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL harmonising certain aspects of insolvency law as available under the following link.

[4] ISDA draft Comment Paper as of 2 May 2023.

[5] The Proposed Directive pursues this objective according to the European Commission's impact assessment (IA) accompanying the Proposed Directive. The IA is available under the following link and addresses especially on its pages 156 et seq. problems caused by disincentives for cross-border investment resulting from differences among and inefficiencies of the Member States' national insolvency laws.

[6] Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132, available under the following link, addressing two aspects of the bankruptcy code: the 'pre-insolvency procedure' and the debt discharge following the closure of insolvency proceedings. It provides the tools for restructuring the debts 'before insolvency' but does not provide a framework for the liquidation of assets of insolvent debtors. It rather aims to help companies in distress avoid insolvency by giving them access to preventive schemes that allow them to restructure their debts and possibly return to viable business. The directive does not address insolvency proceedings as such; instead, it provides a legal framework for the 'discharge' of debts as the outcome of insolvency proceedings.

[7] Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings, available under the following link. Regulation (EU) 2015/848 determines the territorial jurisdiction of insolvency proceedings and the law applicable to cases of cross-border insolvency. It does not touch upon the 'content of insolvency law'. Instead, it seeks to enhance both cross-border information sharing and the application of insolvency proceedings and decisions. The regulation introduces uniform rules on international jurisdiction (that is, the EU Member State that should open insolvency proceedings) and on the applicable law for cases of cross-border insolvency. In parallel, it introduces uniform rules ensuring that the judgments made by the courts having jurisdiction in such cases are recognised, and if needed, enforced across all Member States. It has no impact on the content of national insolvency law. It determines the applicable law but does not prescribe any features or minimum standards for that law. Therefore, it does not address the discrepancies among the Member States' insolvency laws (and the resulting problems and costs).

The Proposed Directive targets the three key dimensions of insolvency law**, without being in any way specific to energy or energy derivative trading**:

1. the recovery of assets from the liquidated insolvency estate;
2. the efficiency of proceedings; and
3. the predictable and fair distribution of recovered value among creditors.

a) Status of legislative process

After the Proposed Directive was published on **7 December 2022,** the Council of the European Union started discussions on the Proposed Directive on 12 December 2022 within the Council and/or its preparatory bodies. Within this framework, the Portuguese Parliament[8], the Czech Senate[9] and the Chamber of Deputies of the Czech Republic[10] have published their opinions on the Proposed Directive. Beyond that further opinions have been drafted, for example by the European Economic and Social Committee (**EESC** – Rapporteur Sandra Parthie)[11], the European Data Protection Supervisor Wojciech Rafał Wiewiórowski[12] and the German Bundesrat[13].

In the European Parliament, the referral was announced in plenary on 26 January 2023, and the Proposed Directive was assigned to **the Committee on Legal Affairs (JURI)** with Pascal Arimont (EPP, Belgium) as rapporteur. The Committees on Economic and Monetary Affairs (ECON)[14] and on Internal Market and Consumer Protection (IMCO) have been asked to give opinions; what IMCO has declined. The first reading in the European Parliament is yet to be held.

[8] Published on 14 March 2023, available under the following link.
[9] Published on 15 March 2023, available under the following link. The Czech Senate inter alia criticizes that, although the aim of the proposal is to increase the efficiency of insolvency proceedings, some elements of the proposal would, on the contrary, lead to an increase in costs and a decrease in the speed of these proceedings in the Czech Republic.
[10] Published on 21 April 2023, available under the following link.
[11] Published on 27 March 2023, available under the following link, concluding that the EESC "*doubts whether the proposal, which is presented as an important step in closing relevant gaps for the improvement of the EU's Capital Market Union, can actually fulfil this expectation. The proposal falls short of providing a harmonised definition of insolvency grounds and the ranking of claims, both of which are key to achieving greater efficiency and limiting the existing fragmentation in national insolvency rules.*" Having that said, the EESC urges the Commission, the Parliament and the Council to revise the proposal (see p. 4).
[12] Published on 10 March 2023, a summary is available under the following link, the full text under the following link. The opinion focusses mainly on data protection issues (calling for safeguarding personal data and limiting the scope of data sharing under the proposal).
[13] Published on 31 March 2023, available under the following link. It criticizes the legal basis, the proposal in general and Titles II, IV, VI and VII of the proposal in particular.
[14] Discussions of ECON can be accessed under the following link; the vote in the ECON Committee is for now scheduled for the 28th of November 2023. After that, the opinion will be forwarded to the JURI Committee, which is scheduled to vote on the file on the 12th of February 2024.

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According to the ordinary legislative procedure under Art. 294 TFEU, the procedure comprises one or two readings and, if needed, a conciliation procedure and a third reading.

After the Proposed Directive prompted lots of criticism[15], the current state of the legislative procedure offers many opportunities for improvement, which leaves room for EFET to raise suggestions and concerns.[16]

b) Summary of Proposed Directive

The text of the Proposed Directive is divided into 9 Titles. Besides Title I and IX (general and final provisions) the contents of each Title is as follows[17]:

i) **Title II** stipulates as minimum harmonization standard three distinct grounds for avoidance behaviors (preferences, acts at an undervalue, and intentionally detrimental actions) and explicit repercussions for such conduct.

ii) The Proposed Directive addresses in **Title III** insolvency proceedings and the way information on available assets would have to be traced and obtained from banks and national registries. Tracing would be conducted by the designated court, empowered to 'access and search its national centralised account'[18].

iii) **Title IV** allows for the preparation and negotiation of the sale of the debtor's business as a going concern before the formal opening of the insolvency proceedings (so called **pre-pack proceedings**[19]).

iv) Once directors become aware that the company is bankrupt, **Title V** requires them to apply for insolvency procedures within three months. Directors are personally responsible for any losses suffered by creditors due to a breach of this commitment.

[15] See for example the above mentioned opinions of EESC, the Czech Senate or the opinion of the German Bundesrat.
[16] The European legislative procedure can take from 18 months to a few years. Once implemented, Member States will have two years to transpose the Directive into national law.
[17] See also Art. 1 (1) of the Proposed Directive.
[18] As established pursuant to Article 32a of Directive 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing.
[19] As defined in Art. 2 (p) Proposed Directive meaning expedited liquidation proceedings that allow for the sale of the business of the debtor, in whole or in part, as a going-concern to the best bidder, with a view to the liquidation of the assets of the debtor as a result of the established insolvency of the debtor.

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In **Title VI** the Proposed Directive also aims to render the winding up of insolvent **microenterprises**[20] more efficient and to simplify the associated proceedings. In particular, an insolvency practitioner is only appointed on the request of one of the parties and the cost is covered by the insolvency estate or by the requesting party.

v) **Title VII** contains provisions on the establishment of the creditors' committee. While it is up to the creditors to decide whether to establish a creditors' committee, the Member States are given discretion in national law to exclude the possibility of establishing such a committee when the cost of setting it up and operating it is not justified. The creditors' committee is appointed by the creditors or the court.

vi) In order to enhance transparency of national insolvency laws, **Title VIII** requires Member States to provide key features of national insolvency regimes, including insolvency triggers and the ranking of claims.

3. Key items

As regards potential impact on **energy trading**, we have identified the following as key items of the Proposed Directive:

a) Harmonization of Avoidance Actions

The Proposed Directive would require Member States to ensure that preferences, transactions for inadequate consideration and acts intentionally detrimental to creditors can be set aside if they take place within prescribed periods[21] prior to the opening of insolvency proceedings. Member States would be able to adopt or maintain additional provisions relating to the voidness, voidability or unenforceability of legal acts[22] detrimental to the general body of creditors in the context of insolvency

[20] According to Art. 2 (j) Proposed Directive, the term microenterprise is used within the meaning of the Annex to Commission Recommendation 2003/361/EC, which defines a microenterprise as 'an enterprise which employs fewer than 10 persons and whose annual turnover and/or annual balance sheet total does not exceed EUR 2 million' (Annex, Article 2 (3)).
[21] Prescribed period depends on the legal act in question:
- Legal acts under Art. 6 Proposed Directive (preferences) within **three months** prior to the submission of the request for the opening of insolvency proceedings;
- Legal acts under Art. 7 (transactions for inadequate consideration) within a time period of **one year** prior to the submission of the request for the opening of insolvency proceedings;
- Legal acts under Art. 8 (acts intentionally detrimental to creditors) within a time period of **four years** prior to the submission of the request for the opening of insolvency proceedings.

[22] Legal act means any human behavior, including an omission, producing a legal effect according to Art. 2 (f) Proposed Directive.

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proceedings where such provisions provide a greater protection of the general body of creditors.

In that context, the Proposed Directive contains **minimum standards**; most jurisdictions already foresee even stronger protection of the general body of creditors which can survive the national implementation of the Proposed Directive.[23]

Unlike other legislations, however, such as the Financial Collateral Directive[24] (**FCD**), the Proposed Directive does not contain any legal privilege regarding acts related to the provision or exchange of collateral.

Currently, the Proposed Directive does also not include a general provision ensuring that, in the first place, the Settlement Finality Directive[25] (**SFD**), FCD and **EMIR**[26] apply notwithstanding the provisions of the Proposed Directive. In addition, as said above, the Proposed Directive does not address protection for set-off and netting provisions not covered by the FCD.

If passed without amendment, the Proposed Directive would have, however, a neutral effect in most jurisdictions, because member states would likely uphold the current status provided for by the FCD. On the other hand, as the privileges under the FCD are largely limited to financial institutions, it has been EFETs position in the past, to support a broader exemption and extent the scope to non-financial market participants.

Provisions of the FCD do not, for example, protect close-out netting provisions in EFET General Agreements[27] (**EFET GAs**) where both counterparties do not belong to the categories specified in the FCD as applied in the relevant Member State.

[23] For example: France and Germany already have stringent Avoidance Action regimes. In France, certain look-back periods (so called "*période suspecte*") may need amendment while possibly Germany's current laws will remain unchanged. However, even though claw-back regimes do exist in the Netherlands (Dutch Bankruptcy Act), Spain and Italy (Decree 14/2019), those regimes may need to be revised. For details, see Cordewener/Chiaves/Hansen in: IFLR, EU insolvency law harmonisation not an easy feat, published on 25 September 2023 and available under the following link.

[24] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, available under the following link.

[25] Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems, available under the following link.

[26] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories, available under the following link.

[27] EFET GAs or EFET GA in the following used for both EFET-GA Electricity and EFET-GA Natural Gas.

Such close-out netting provisions should also be protected in the same way as close-out netting provisions that fall under the FCD. We elaborate on this further below[28].

b) Pre-pack proceedings

The Proposed Directive introduces pre-pack proceedings in which the sale of the debtor's business is negotiated before the opening of insolvency proceedings and the sale executed shortly after the opening of such proceedings. Key features of such proceedings are:

- An optional stay of individual enforcement actions in the preparatory phase[29]
- the need for a court to authorize the pre-pack sale, and
- the fact that necessary ongoing contracts would generally be assigned to the purchaser, even without the consent of the contractual counterparty/ies.

The Proposed Directive would require Member States to ensure that the acquirer of the debtor's business or part thereof in a pre-pack sale is assigned the executory contracts[30] which are necessary for the continuation of the debtor's business and the suspension of which would lead to a business standstill. The Proposed Directive would require Member States to **override** any restrictions on assignment in the EFET-GA requiring consent of the debtor's counterparty or counterparties. There would only be a limited exception if the acquirer of the debtor's business or part thereof is a competitor to the debtor's counterparty or counterparties[31].

Further, the Proposed Directive foresees that the acquirer of the debtor´s business shall be entitled to acquire the business or parts thereof **free of debts** and **liabilities**.

The Proposed Directive could insofar conflict with the protection counterparties provided for in the EFET-GA. It could, for example, potentially allow the transfer of individual transactions that are part of a single netting or hedging set[32], adversely

[28] See 4a).
[29] In accordance with Art. 6 and 7 of Directive (EU) 2019/1023.
[30] Executory contract means a contract between a debtor and one or more counterparties under which the parties still have obligations to perform at the time of the opening of insolvency proceedings in the liquidation phase as defined in Art. 2 (g) Proposed Directive.
[31] As outlined in Art. 27 (1) Proposed Directive.
[32] Which, for example may form part of a single agreement according to § 1.1 of the EFET-GA.

affecting the rights of the parties under collateral arrangements or netting and set-off arrangements.

In addition, it prohibits the other party from refusing a transfer to a party, which has not the required creditworthiness or is not compliant with internal onboarding requirements.

As preliminary conclusion, such pre-pack proceedings should not overwrite contractual assignment clauses[33], the single agreement concept and material termination events. We will discuss this in more detail below[34].

Further, member states in which consent from holders of secured claims is required in winding-up proceedings for the release of security interests, **may depart from requiring such consent**[35], provided that the security interests relate to assets that are necessary for the continuation of the day-to-day operations of the debtor's business or part thereof, if either

- creditors of secured claims fail to prove that the pre-pack offer does not satisfy the best-interest-of-creditors test; or
- creditors of secured claims have not filed an alternative binding acquisition offer that allows the insolvency estate to obtain a better recovery than with the proposed pre-pack offer.

As a result, creditors holding rights under financial collateral agreements, may enjoy lesser protection than before.

c) Director Duties

The proposal will oblige Member States to ensure they have legislation in place which obliges directors to file for insolvency proceedings **within 3 months** after they became aware or can reasonably be expected to be aware of the insolvency. If they fail to do so they will be liable to creditors for damages incurred as a result of their failure to commence insolvency proceedings.

[33]Such as § 19 EFET-GA.
[34] See 4b).
[35] Art. 34 Proposed Directive – this, however, is not a mandatory provision and member states which currently require such consent can continue to do so.

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Many Member States foresee this duty already or have even much stricter obligations in place[36].

In any case, the language in the EFET-GA would apply as before to such institutions. However, the termination provisions including AET[37] might require review due to timing issues, depending on the final wording of the Proposed Directive and its transposition into national law.

4. Areas of concern for energy trading and potential amendment proposals

a) No protection of material termination rights and netting provisions in the Proposed Directive when exercising avoidance rights.

Here, a **general carve out of trading instruments** would be beneficial. The Proposed Directive should therefore be amended to include a provision ensuring that other close-out netting provisions (i.e. close-out netting provisions under contracts that are not close-out netting provisions as defined in the FCD) are **enforceable in accordance with their terms**, e.g.:

> *Member States shall ensure that other close-out netting provisions are enforceable in accordance with their terms notwithstanding the national measures implementing the provisions of this Directive where those other close-out netting provisions would otherwise be enforceable in accordance with national insolvency law[38].*

Other close-out netting provisions could be defined as follows[39]:

> *'other close-out netting provision' means a provision of a financial arrangement or of an wider arrangement of which such a financial arrangement forms part, or, in the absence of any such provision, any statutory rule by which, on the occurrence of an enforcement event, whether through the operation of netting or set-off or otherwise:*

[36] E.g. in Spain (directors must file for formal insolvency within 2 months), France (debtors have to declare cessation of payments within 45 days) or Germany (usually 3 weeks, depending on the insolvency reason). However e.g. in the Netherlands, the liability for late filing will be a new concept in the legal system. For details, see Cordewener/Chiaves/Hansen in: IFLR, EU insolvency law harmonization not an easy feat, published on 25 September 2023 and available under the following link.
[37] §§ 10.4 and 10.5(c) EFET-GA
[38] Identical to current ISDA-Proposals.
[39] Combination of ISDA Proposal and EFET-member comments.

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(i) the obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value, or are terminated and replaced by an obligation to pay such an amount; and/or
(ii) an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party (and which is not a close-out netting provision as defined in point (n) of Article 2(1) of [the FCD]).

Financial Arrangement means:

(a) a financial contract (see further below) as defined in Art 2(1)(100) of BRRD[40];

(b) a contract for delivery on an intra-day basis which would be a financial contract if it were for delivery on a future date ("spot commodity contract");

(c) a contract that would be a financial contract or a spot commodity contract, if the term "commodity" in the definition of "financial contract" also included any (1) emissions allowance or credit or (2) other renewable energy or green certificate, permit, credit or allowance;

(d) a derivative contract, other than any contract already covered in (a)-(c) above, as defined in article 2(5) of the European Market Infrastructure Regulation (648/2012/EU);

(e) a securities financing transaction as defined in Art 3(11) of SFTR, a commodity leasing transaction, or a similar transaction to any of them,

[40] Point (100) of Article 2(1) of BRRD provides as follows:
'financial contracts' includes the following contracts and agreements:
(a) securities contracts, including: (i) contracts for the purchase, sale or loan of a security, a group or index of securities; (ii) options on a security or group or index of securities; (iii) repurchase or reverse repurchase transactions on any such security, group or index;
(b) commodities contracts, including: (i) contracts for the purchase, sale or loan of a commodity or group or index of commodities for future delivery; (ii) options on a commodity or group or index of commodities; (iii)
repurchase or reverse repurchase transactions on any such commodity, group or index;
(c) futures and forwards contracts, including contracts (other than a commodities contract) for the purchase, sale or transfer of a commodity or property of any other description, service, right or interest for a specified price at a future date;
(d) swap agreements, including: (i) swaps and options relating to interest rates; spot or other foreign exchange agreements; currency; an equity index or equity; a debt index or debt; commodity indexes or commodities; weather; emissions or inflation; (ii) total return, credit spread or credit swaps; (iii) any agreements or transactions that are similar to an agreement referred to in point (i) or (ii) which is the subject of recurrent dealing in the swaps or derivatives markets;
(e) inter-bank borrowing agreements where the term of the borrowing is three months or less;
(f) master agreements for any of the contracts or agreements referred to in points (a) to (e).

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including a similar transaction with respect to any (1) emissions allowance or credit or (2) other renewable energy or green certificate, permit, credit or allowance; or

(f) a master agreement in so far as it relates to any of the contracts or agreements referred to in points (a) to (e);

"commodity" has the meaning as provided for in Article 2 (6) of the Delegated Regulation (EU) 2017/565[41].

With this provision, nationally accepted netting clauses could be largely protected against avoidance actions exercised by insolvency administrators. However, to push through this proposal appears to be quite ambitious, as it meant a significant improvement compared to the status quo and there will most likely be resistance on the side of insolvency practitioners because of the limitation of their rights.

b) Assignment of contracts without counterparty consent

The current wording of the Proposed Directive in Art 27 (1) reads:

Assignment or termination of executory contracts

1. Member States shall ensure that the acquirer of the debtor's business or part thereof is assigned the executory contracts which are necessary for the continuation of the debtor's business and the suspension of which would lead to a business standstill. The assignment shall not require the consent of the debtor's counterparty or counterparties.

The first subparagraph shall not apply if the acquirer of the debtor's business or part thereof is a competitor to the debtor's counterparty or counterparties.

[41] Article 2 (6) of the Delegated Regulation (EU) 2017/565 provides as follows: 'commodity' means any goods of a fungible nature that are capable of being delivered, including metals and their ores and alloys, agricultural products, and energy such as electricity.

The Proposed Directive should be amended (in red) as follows:

> *The first subparagraph shall not apply to parts of executory contracts only, in particular if individual transactions are bundled to a single agreement under one and the same framework contract.*
>
> *The first subparagraph shall further not apply if the acquirer of the debtor's business or part thereof is of insufficient creditworthiness, a competitor to the debtor's counterparty or counterparties, or if the performance of executory contracts towards the acquirer of the debtor's business would violate applicable law, including Anti-Money-Laundering provisions and ESG-criteria, all based on the reasonable assessment of the debtor's counterparty or counterparties.*

With that proposal, the legitimate interests of the counterparties of the debtor would be better protected. Further, with the limitation to entire contracts, preexisting netting sets under one and the same framework contract, i.e. EFET-GA, could be maintained. In the alternative, even better protection could be achieved by **maintaining the contractual consent requirement** to any assignment entirely and consequently sentence 2 of para 1 be deleted. However, this would touch upon the core of the current proposal and might be viewed as too ambitious.

c) Application of SFD, FCD and other regulation

Unlike EFET members, ISDA-members do regularly stem from the financial sector. Therefore, their legislative proposals do often address particularities of financial regulation with limited impact to non-regulated, non-financial counterparties.

In that respect, ISDA has brought forward the following proposal[42]:

“Protection of settlement finality, financial collateral and clearing”

“The proposed Directive should be amended to include a provision based on Article 31 (1) of the Restructuring Directive making clear that the SFD, the FCD

[42] See p. 8 of the ISDA draft Comment Paper as of 2 May 2023.

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and EMIR apply notwithstanding the provisions of the proposed Directive (and Article 6(3)(c) should then be deleted), e.g.:"

The following acts shall apply notwithstanding this Directive:

(a) Directive 98/26/EC;

(b) Directive 2002/47/EC; and

(c) Regulation (EU) No 648/2012."

EFET should consider to **support** this proposal albeit its membership would to a large extent not benefit therefrom directly. It is however clear and should be further expressed in the Proposed Directive, that the Proposed Directive should **not** be used by member states to draw back the protection of collateral in insolvency scenarios, already achieved by the FCD, SFD and EMIR.

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