

# ISDA

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European Commission  
Directorate-General for Justice and Home Affairs  
Unit A3 - Cooperation in Civil Matters  
B-1049 Brussels

Dear Sirs,

**Green Paper on the conversion of the Rome Convention of 1980 on the law applicable to contractual obligations into a Community instrument and its modernisation**

We are pleased to respond to your invitation for interested parties to reply to the questions raised in the Green Paper, presented by the Commission on 14th January, 2003, on the conversion of the Rome Convention of 1980 on the law applicable to contractual obligations into a Community instrument and its modernisation.

The International Swaps and Derivatives Association, Inc. (ISDA) is the global trade association representing leading participants in the privately negotiated derivatives industry, a business that includes interest rate, currency, commodity, credit, and equity swaps, options, and forwards, as well as related products such as caps, collars, floors, and swaptions. Additional information on ISDA, its European membership and its interest in the development of European law affecting the financial markets is set out in the Annex to this letter.<sup>1</sup>

Promoting legal certainty for cross-border financial transactions through law reform is one of ISDA's key objectives. A considerable proportion of the resources of ISDA and its members is devoted to acquiring legal opinions from a wide range of jurisdictions on netting, set-off and collateral arrangements.

The scope of the Rome Convention and, therefore, of the issues raised by the Green Paper extends to the contractual aspects of all sectors of commercial life, including consumer transactions. ISDA's own mission is limited to the wholesale financial markets, that is, to privately negotiated (over-the-counter) derivatives transactions between professional financial market participants, including corporate and governmental end-users. In light of this, we are not able to comment on all questions raised in the Green Paper, but have limited our comments to those aspects that are likely to affect the legal certainty of wholesale financial market transactions, including privately negotiated derivatives.

Before turning to certain of the specific questions raised in the Green Paper, we would make the following general observations:

- It is of paramount importance to the financial markets that private international rules be clear, consistent and certain in their scope and application. Some aspects of the Rome Convention would benefit from further study

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<sup>1</sup> For further information on ISDA, please also consult our website at <http://www.isda.org>.

and careful amendment. If this can be accomplished, as contemplated by the Green Paper, during the course of conversion of the Rome Convention into a Community instrument, then we endorse the Commission's decision to open an open dialogue on this possibility.

- To the extent that the Rome Convention has worked reasonably well, though, it is essential that any changes are, indeed, improvements and do enhance clarity, consistency and certainty. ISDA therefore urges the Commission to proceed with due deliberation in this matter and urges it to continue to consult financial market participants and appropriate national legal experts in the various member states.
- ISDA notes that the Commission has drawn attention to the relationship between the possible conversion of the Rome Convention into a Community instrument and the issues raised in the Commission's Communication of 12 February 2003 on "A More Coherent European Contract Law: An Action Plan", on which we commented in our letter to the Commission of 16 May 2003. We agree that it is worthwhile pursuing these projects in tandem and in ensuring consistency between them.

We now turn to those questions posed in the Green Paper that have a direct impact on the activities of ISDA and its members.

***Question 1 - Do you have information concerning economic actors' and legal practitioners' actual knowledge of the Rome Convention of 1980 and of its rules, in particular the rule allowing parties to freely choose the law applicable to their contract? If you consider that such knowledge [is] insufficient, do you think that this situation has a negative impact on the parties' conduct in their contractual relations or on court proceedings?***

ISDA's members are sophisticated participants in the professional wholesale financial markets. They are aware of their freedom to choose the law applicable to their contractual arrangements. A large proportion of the global market for privately negotiated derivatives is documented under ISDA Master Agreements governed by English law or New York law, the choice of the latter being recognised under the Rome Convention by virtue of Article 2. ISDA members regularly take both internal and external legal advice on questions relating to the law applicable to their contractual arrangements, including, where appropriate, on the more detailed implications of the Rome Convention.

***Question 2 - Do you believe the Rome Convention of 1980 should be converted into a Community instrument? What are your arguments for or against such a conversion?***

ISDA is aware that not all of its members have the same view on this question, and therefore we are not able to express a consensus view in answer to this question. Clearly, though, all would agree that any conversion to a Community instrument should enhance legal certainty rather than give rise to new uncertainties.

The arguments against converting the Rome Convention into a Community instrument would include the fact that the Rome Convention has served the markets reasonably well since it first came into effect. Since it is a "known" element of the legal framework within which the European financial markets currently operate, it is arguably better to preserve it in its current form than to risk the uncertainty that might accompany a conversion to a Community instrument. This is particularly so where, as discussed elsewhere in the Green Paper, substantive amendments, which might be of uncertain effect, to various aspects of the Rome Convention would most likely be made as part of the conversion process.

The arguments for converting the Rome Convention into a Community instrument would include (1) the benefit of having a consistent European legislation framework for private international law, following the conversion of the Brussels Convention of 1968 to a Community instrument, (2) the benefit of having a regime common to all EU member states rather than the current somewhat heterogeneous Rome Convention regime resulting, among other things, from reservations made by certain member countries, and (3) the benefit of having the European Court of Justice as the final single arbiter of the meaning of the

Community instrument (with, therefore, hopefully, a unifying effect on jurisprudence on the Community instrument in the national courts), as opposed to the current situation, where the First Protocol on the Interpretation by the Court of Justice of the European Communities has never come into effect.

Without prejudging the merits of converting the Rome Convention into a Community instrument, we would suggest that, if the decision is made to do so, a Regulation would be preferable to a Directive, to help ensure consistency and uniformity of effect via the direct effect of the Regulation. This would have the additional merit of being consistent with the approach taken in relation to the conversion of the Brussels Convention of 1968 into the Brussels I Regulation.

***Question 3 - Are you aware of difficulties encountered because of the proliferation and dispersal of rules having an impact on the applicable law in several horizontal and sectoral instruments of secondary legislation? If so, what do you think is the best way of remedying them?***

While ISDA has no specific comments to offer on this highly technical issue, we commend the Commission for raising this question and urge the Commission to study this in detail, with appropriate input from national legal experts, to ensure consistency and uniformity as far as possible across these various instruments, as well as with the general framework that applies where a horizontal or sectoral instrument is not relevant. Clearly, we are particularly concerned with those instruments that impact the wholesale financial markets.

***Question 4 - Do you think a possible future instrument should contain a general clause guaranteeing the application of a Community minimum standard when all elements, or at least certain highly significant elements, of the contract are located within the Community? Does the wording proposed at 3.1.2.2 allow the objective pursued to be attained?***

ISDA believes that while a general clause guaranteeing the application of a Community minimum standard may be appropriate in a consumer context, it would not be appropriate in the context of commercial transactions, including wholesale financial market transactions. The concept and scope of a Community minimum standard would be difficult to define and to apply, creating legal uncertainty.

This derogation from the basic principle of freedom of contract would not, in our view, be justified by any clear policy objective in relation to transactions between market professionals and sophisticated corporate and governmental end-users of financial products. Rome Convention rules relating to the application of mandatory rules (regarding which, see our further comments below) would continue to apply, we assume, and should provide adequate protection of national public policy interests in the context of financial transactions between professional and commercial counterparties.

***Question 5 - Do you have comments on the guidelines [relating to the potential relationship between a possible Community instrument and existing international conventions]?***

ISDA offers no specific comments on the proposed guidelines, but endorses the objective of avoiding conflicts between a possible Community instrument and existing international conventions and minimising the possibility of divergent rules arising in different member states.

***Question 6 - Do you think one should envisage conflict rules applicable to arbitration and choice of forum clauses?***

ISDA understands that the exclusion of arbitration and choice of forum rules from the Rome Convention was not intended at the time the Rome Convention was prepared to be a permanent exclusion from the regime contemplated by the Rome Convention. If the decision were made to convert the Rome Convention into a Community instrument, it would appear to be worthwhile including such clauses.

While the forms of Master Agreements published by ISDA do not contain arbitration clauses, members of ISDA are perfectly free to amend their agreements to provide for arbitration, where that appears to be appropriate. ISDA is aware that members do sometimes provide for arbitration when dealing, for example, with a counterparty based in a jurisdiction (for example, certain emerging market jurisdictions) where an arbitral award would be more easily enforced than a judgement of a New York or English court.

***Question 8 - Should the parties be allowed to directly choose an international convention, or even general principles of law? What are the arguments for or against this solution?***

The Green Paper refers to the "common practice" in international trade of referring not to the law of one or other state, but to the rules of an international convention, "general principles of law", or something similar. While this may be common practice in some commercial sectors, it is virtually unknown in the wholesale financial markets, although we believe that allowing the parties this possibility is consistent with the policy objective of permitting freedom of contract as far as possible.

Having said that, we simply note that parties to a wholesale financial markets agreement, such as the ISDA Master Agreement, normally prefer the commercial law regime of one of the leading industrialised countries, with its detailed jurisprudence and experienced commercial courts, to the other possibilities mentioned in this context in the Green Paper. As noted above, in cross-border privately negotiated derivatives transactions, parties most commonly choose either New York law or English law.

***Question 10 - Do you believe that Article 4 should be redrafted to compel the court to begin by applying the presumption of paragraph 2 and to rule out the law thus obtained only if it is obviously unsuited to the instant case? If so, how do you think it would be best drafted?***

The vast majority of privately negotiated derivatives transactions entered into by ISDA members are documented under an ISDA Master Agreement including an express choice of law. Article 4 will therefore normally not apply.

It does, however, sometimes happen that trades are not documented or at least not fully and formally documented, and in those circumstances Article 4 could apply. ISDA therefore would support a clarification of the operation of Article 4. How Article 4 should be clarified, however, will require careful study.

We also note the reference in point 1.5 of the Green Paper that "the obligation to pay an amount of money does not [...] constitute the characteristic performance for the purposes of Article 4 [of the Rome Convention]". The obligations of parties to financial transactions in general, and privately negotiated derivatives in particular, are often limited to reciprocal payment obligations. While in some cases, one might identify one party's payment obligation as the "characteristic performance" (for example, the obligation of the seller of a simple cash-settled option), it is easy to imagine transactions where there is no clear basis on which to determine the "centre of gravity" of the contract on this basis.

Article 4 should also be studied with the effects of modern telecommunications and other technological developments in mind.

***Question 13 - Should the future Rome I instrument specify the meaning of "mandatory provisions" in Articles 3, 5, 6 and 9 and in Article 7?***

While we make no comment specifically on Articles 5 or 6, which fall outside ISDA's area of concern as an international financial markets trade association, we do believe that a carefully thought-through clarification of the meaning of the terms "mandatory provisions" and "mandatory rules" would be beneficial for parties to cross-border financial contracts and their advisers. To do this properly would require detailed consultation with national legal experts.

In framing this clarification, the necessity of preserving freedom of contract for cross-border financial and commercial counterparties should be borne firmly in mind, as well as the desirability of reinforcing legal certainty (and minimising the risk of legitimate expectations being defeated) by restricting as far as possible the potential interference of mandatory rules developed for other contexts (for example, the consumer) in otherwise legitimate contractual arrangements between sophisticated financial and commercial counterparties.

***Question 16 - Do you believe there should be rules concerning foreign mandatory rules in the meaning of Article 7? Would it be desirable for the future instrument to be more precise on the conditions for applying such rules?***

For the reasons given and subject to the caveats in our response to Question 13, we believe that clarification of the scope and effect of Article 7 would be beneficial.

***Question 17 - Do you think that the conflict rule on form should be modernised?***

We would support the modernisation of Article 9, taking into account the different ways in which contractual relationships are now formed. Again, though, careful study of these issues would be required. We would welcome the opportunity to participate in future consultations on these issues.

***Question 18 - Do you believe that a future instrument should specify the law applicable to the conditions under which the assignment may be invoked against third parties? If so, what conflict rule do you recommend?***

We do believe that this issue merits further careful study, as legal certainty as to assignment of financial assets is fundamental to the successful operation of the international financial markets. We are not aware, however, of there being a consensus among our members on the ideal approach, and so in this letter we are not able to offer any specific recommendations. We do believe, however, that our members would support greater uniformity among the member states in the approach they take to these issues.

Account should be taken in any developments in this area of the intangible nature of the assets transferred in the financial markets, particularly in relation to securities, which are predominantly handled by transfers between accounts maintained with financial intermediaries (including central securities depositories and other financial custodians, their sub-custodians and nominees).

A number of Community instruments already have a bearing on these issues, including the Settlement Finality Directive,<sup>2</sup> the Collateral Directive,<sup>3</sup> and the Insolvency Regulation<sup>4</sup>. International work on these issues is proceeding in a number of fora, and has already resulted, for example, in the signing last December of the Hague Convention on the law applicable to certain rights in respect of securities held with an intermediary. Coordination with and, as far as possible, consistency with these other instruments and conventions is highly desirable, to promote legal certainty and reinforce the confidence of the international market participants in the integrity of the European legal framework for financial transactions.

Coordination and consistency with the Hague Convention is essential to promoting legal certainty. Once again, we would welcome the opportunity to participate in any future consultation in this regard.

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<sup>2</sup> Directive 98/26/EC on settlement finality in payment and securities settlement systems.

<sup>3</sup> Directive 2002/47/EC on financial collateral arrangements.

<sup>4</sup> Regulation 2000/1346/EC on insolvency proceedings.

***Question 19 - Would it be useful to specify the respective scope of Articles 12 and 13? Do you believe that there should be a conflict rule for subrogation payments made in the absence of an obligation?***

We do believe that clarification of the scope of Articles 12 and 13 would be useful. We are not entirely certain what is meant by "subrogation payments" in paragraph 3.2.14.2 of the Green Paper, but if the suggestion is that subrogation should arise in a situation where the party seeking subrogation has made a payment on behalf of a debtor without being under a contractual obligation to do so, then we would not support the inclusion of such a provision within the scope of the Rome Convention or any future Rome I instrument. We believe that such a provision would potentially have unpredictable consequences, for example, in relation to the credit derivatives market, with potentially harmful ramifications in other areas of the financial markets.

***Question 20 - In your view, would it be useful to specify the law applicable to legal compensation? If so, what conflict rule do you recommend?***

We note the reference in point 3.2.15 of the Green Paper to the "absence of [a] conflict rule relating to [the] offsetting of claims". The enforceability of close-out netting, set-off and collateral arrangements is fundamental to the soundness of the international financial markets. As mentioned above, a large proportion of these arrangements are entered into under an ISDA Master Agreement governed by English law or New York law, often between financial market participants where at least one of the parties, particularly if it is a derivatives dealer, is based, or has significant operations, in a member state of the European Union. It is therefore of particular importance that private international law in general, and the identity of the law governing set-off in particular, be beyond question.

In relation to the points raised in paragraph 3.2.15 of the Green Paper, as regards the setting off of claims prior to the onset of any insolvency (or bankruptcy, as appropriate) proceedings, we note the reference in the Green Paper to the absence of a Community-wide law relating to the setting off of mutual claims governed by different laws. While the current position is that, in the absence of contractual agreement between the parties, the law which governs the setting off of mutual claims will be determined in accordance with the private international law of the courts determining the issue, we understand that as a broad general principle the question of whether a claim has been discharged by set-off between solvent parties is governed by the law of the claim which the debtor asserts has been discharged by the set-off (which in the usual case will be the law of the creditor's primary claim).

ISDA considers that caution should be taken when considering whether to alter the current position in relation to the law governing the set-off of mutual claims, as any such alteration may serve to cause more uncertainty in the international financial markets. Any consideration of the law governing the set-off of mutual claims between solvent parties should, of course, be consistent with the treatment in the Insolvency Regulation of the offsetting of mutual claims by or against an insolvent party.

Additionally, to the extent that the law governing the set-off of mutual claims is addressed by a Community instrument, caution should be taken when seeking to identify and distinguish between the types of set-off available to creditors. We note the reference to "legal compensation" in Question 20, which we take to mean "legal set-off". The identity of a remedy as "legal" set-off will, of course, differ between jurisdictions within the Community, particularly in light of the differences between the common law and civil law approaches. A private international law rule relating to one type of "legal" set-off (that is, set-off arising under a particular statute - for example, what is sometimes termed "independent set-off" between unconnected claims) may, for good policy reasons, vary from the appropriate private international law rule for another type of "legal" set-off (that is, arising by operation of law under general principles, for example, what is sometimes termed "transaction set-off" between connected claims).

In this context, it is also crucial to bear in mind the fundamental importance of close-out netting to the successful operation of and the management of system risk within the international financial markets.

Close-out netting is a term that encompasses various ways of achieving a net balance under a bilateral or multilateral financial arrangement. While in some contracts it relies on contractual set-off, in other contracts it relies on legal mechanisms such as novation or the creation of a "flawed asset". Indeed, it is our understanding that, strictly speaking, close-out netting under an ISDA Master Agreement under English law and under New York law does not rely on contractual set-off but instead on the "flawed asset" concept, although contractual set-off clauses are also relied on to permit a non-defaulting party to set off its net position under the ISDA Master Agreement against other amounts owed by or to the defaulting party.

Various Community instruments draw a distinction between netting and set-off, including the Collateral Directive and the Winding Up Directives for insurance undertakings<sup>5</sup> and for credit institutions<sup>6</sup>. It is important, therefore, that this distinction be addressed in any revision of the rules in this area.

ISDA is concerned that legal certainty in relation to enforceability of set-off and collateral arrangements under the laws of each member state should be maintained, and not adversely affected, should the issue be addressed in a Community instrument relating generally to the law applicable to contractual obligations. Extreme caution should be taken in addressing these complex issues.

We hope that our comments are helpful to you during your considerations. We are fully supportive of any development that will enhance legal certainty for financial market participants, but note that the issues dealt with by the Rome Convention are highly complex and careful study and appropriately broad consultation will be necessary to ensure that any development in this area is a genuine improvement and does not raise significant new uncertainties. We stand ready to provide any information or assistance, for example, regarding international market practice, that may aid the Commission in its further consideration of the issues discussed in the Green Paper.

Any questions or comments regarding our comments on the Green Paper may be addressed to Peter Werner in ISDA's European Office at One New Change, London EC4M 9QQ (tel. +44 20 7330 3550; fax +44 20 7330 3555; e-mail [pwerner@isda-eur.org](mailto:pwerner@isda-eur.org)).

Yours faithfully,

(Dr Peter M Werner, Policy Director Europe)

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<sup>5</sup> Directive 2001/17/EC on the reorganisation and winding up of insurance undertakings.

<sup>6</sup> Directive 2001/24/EC on the reorganisation and winding up of credit institutions.

ANNEX

**The International Swaps and Derivatives Association**

The International Swaps and Derivatives Association, Inc. (ISDA) is the global trade association representing leading participants in the privately negotiated derivatives industry, a business that includes interest rate, currency, commodity, credit, and equity swaps, options, and forwards, as well as related products such as caps, collars, floors, and swaptions.

ISDA was chartered in 1985 and today numbers over 600 member institutions from 46 countries on six continents. These members include most of the world's major institutions who deal in, and leading end-users of, privately negotiated derivatives as well as associated service providers and consultants. A list of ISDA's members is available from the website at <http://www.isda.org>.

Nearly half of ISDA's members are European institutions, with the next largest group being North American (Canada, the USA and Mexico), followed by members from the Asia-Pacific region and South America. Of the 20 primary members represented on ISDA's current Board of Directors, 11 are European institutions. ISDA's members therefore have a deep and longstanding interest in the legal and regulatory framework for financial transactions in Europe.

ISDA is involved on an ongoing basis in promoting law reform, regularly participating in consultations and lobbying on legislative and regulatory developments affecting the financial markets, in Europe, North and South America, and the Asia-Pacific region. Copies of ISDA's responses to public consultations on law reform matters, as well as other policy statements and position papers, are available from ISDA's website at <http://www.isda.org>.

