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Secretariat
International Institute for the Unification of Private Law (UNIDROIT)
Via Panisperna, 28
00184 Roma
ITALY

For the attention of Professor Herbert Kronke, Secretary General

Dear Sirs,

UNIDROIT Project on Transactions on Transnational and Connected Markets

We thank you for your kind invitation to comment, in the context of your project on Transactions on Transnational and Connected Markets (the "**Financial Markets Project**"), on the proposed scope of work on "Harmonised Substantive Rules for the Use of Securities Held with Intermediaries as Collateral" (UNIDROIT 2002, Study LXXVIII, Doc. 1, Rome, June 2002) (the "**Scope of Work on Collateral**").

We understand that the Scope of Work on Collateral was prepared for the restricted Study Group meeting next week in Rome, during which the Financial Markets Project will be discussed, its terms of reference will be established (scope of work, timeframe, and so on), and a proposed list of Observers to be invited will be drawn up.

Further to your correspondence with Edward Murray, who is the Chairman of our Collateral Law Reform Group, we wish to reiterate ISDA's interest in the Financial Markets Project and, particularly, in your proposed work on financial collateral arrangements. We believe that you are familiar with our work in the area of collateral law reform, and in particular our involvement in the consultative process that led to the European Directive on financial collateral arrangements (the "**Collateral Directive**") and our on-going involvement in the consultative process for the proposed Hague Convention on indirectly held securities (the "**Proposed Hague Convention**").

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As recognised in the Scope of Work on Collateral, there are a number of weaknesses in the legal framework for indirectly held securities in many, if not most, jurisdictions around the world.

In Europe, we believe that these weaknesses have largely been addressed in the Collateral Directive, assuming it is properly implemented in each member state. In the US, revised Articles 8 and 9 of the Uniform Commercial Code (the "UCC") have also effectively addressed many of these weaknesses, and similar law reform efforts have modernised the collateral legal regimes, at least in part, in a small number of other jurisdictions. But much work remains to be done.

The Proposed Hague Convention, if signed in December of this year, will deal with the central conflict of laws issues relevant to financial collateral arrangements for the various member states that sign the treaty and implement its provisions. But, of course, the Proposed Hague Convention does not attempt to deal with the other substantive issues covered by the Collateral Directive or the UCC.

ISDA believes that UNIDROIT has a potentially important role to play in promoting the sound principles set out in the Collateral Directive and the UCC in other jurisdictions around the world. Neither the Collateral Directive nor the UCC has necessarily solved all of the problems facing financial market participants establishing financial collateral arrangements in relation to indirectly held securities. The UNIDROIT project offers the opportunity, therefore, not only to extend existing solutions but to add to the common store of knowledge on these issues and to promote new initiatives for national law reform in relation to financial collateral.

We offer the following additional comments on the Collateral Scope of Work for your consideration:

1. The Collateral Scope of Work is an excellent starting point for your discussions that covers most of the key legal issues affecting financial collateral arrangements. We are particularly pleased to note that you propose to direct the attention of the Study Group to the issue of upper-tier attachments.
2. We note that the title "harmonised substantive rules for the use of securities held with intermediaries as collateral" appears broad enough to cover (in addition to security financial collateral arrangements) repos, securities lending, and title transfer collateral, but as there is no specific reference to any of those terms in the Collateral Scope of Work, ISDA wishes to underline the importance of including them.
3. We note that the second item describing the scope refers to the "rights of the account holder (investor) evidenced by the account and transferred to the security taker". If this means clarifying the legal nature of an account holder's interest in securities held in an indirect holding system, we supports this and believes it will bring additional clarity and legal certainty to transactions involving the transfer of such securities (or interests). To that extent, the work of UNIDROIT would go beyond the scope of the Collateral Directive, which does not attempt to address this potentially difficult issue.
4. We propose that the Study Group consider the impact of an indirect holding system on an account holder's right to set off an indirect holding of debt securities against a debt owed directly to an issuer of the securities. This is a complex issue, the answer to which depends, to a considerable extent, on resolving the legal nature of an interest in indirectly held securities. It will also depend on the specific facts of the particular holding pattern (for example, how many tiers of intermediaries there are between the issuer and the ultimate account holder, the location of each such intermediary, the rights created between each party in the chain, and so on).

5. We note that one of the items in the Collateral Scope of Work is "effects of insolvency of account holder (investor), security taker and intermediary", which covers, potentially, a multitude of issues, including some affecting enforcement (regarding which, see our comment below). We would strongly recommend that the Study Group consider the specific issues raised by mark-to-market financial collateral arrangements, which are commonly used, both in relation to organised markets and in relation to over-the-counter collateralised trading, as well as the issues raised by substitutions of collateral, particularly in relation to insolvency rules relating to the "zero hour", preference rules, and rules relating to transactions defrauding creditors.

6. Finally, we note that the Collateral Scope of Work does not specifically mention enforcement of security, although presumably it is implicit in some of the enumerated items. We respectfully suggest that there are various issues relating to enforcement that are particularly deserving of attention, including, among others, (i) whether or not, or under what circumstances, a financial collateral arrangement should be exempted from the effect of an insolvency stay or freeze and (ii) whether or not a taker of security interest collateral should be permitted to appropriate the collateral (for example, by "selling" the collateral to itself rather than to a market counterparty).

It is hopefully apparent from our comments above that we believe this to be an important project, and we wish to assure you of our interest and support. Please do not hesitate to contact us if you think that we may be of assistance in any way. We would be pleased to participate as an Observer in the Study Group, if that is thought appropriate by the members of your Study Group.

Yours faithfully,

Richard Metcalfe
Director of European Policy
Co-Head of the European Office