

# ISDA

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Permanent Bureau  
Hague Conference on Private International Law  
Scheveningseweg 6  
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2 October, 2001

For the attention of: Christophe Bernasconi, First Secretary

Dear Sirs,

## **Proposed Convention on the Law Applicable to Proprietary Rights in Indirectly Held Securities**

Thank you for your invitation to comment on the annotated July 2001 draft of the proposed Convention on the Law Applicable to Proprietary Rights in Indirectly Held Securities. At your kind invitation, we participated as an observer at the experts working group meeting in January 2001, which led to the preparation of a preliminary draft of the proposed Convention. As part of our broader interest in collateral law reform, we have taken a close interest in this project. We have held numerous consultations with our members on the key issues raised by the proposed Convention and have included presentations on the project in various educational initiatives, conferences and seminars we have organised since the preparatory work of the Permanent Bureau on these issues first began last year.

The International Swaps and Derivatives Association (ISDA) is the global trade association representing leading participants in the privately negotiated ('over-the-counter') derivatives industry. ISDA was chartered in 1985 and today has more than 540 member institutions from 41 countries on six continents. As well as most of the world's major institutions that deal in privately negotiated derivatives, these members include many of the businesses, governmental entities and other end-users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. A list of members is attached. Information about ISDA and its activities is available on the Association's web site: [www.isda.org](http://www.isda.org).

ISDA strongly endorses the work of the Member States and the Permanent Bureau of the Hague Conference on Private International Law on the law applicable to proprietary rights in indirectly held securities. We, along with other industry associations and leading financial market participants, have for a number of years highlighted legal uncertainty on and a lack of a harmonised approach to this issue as key impediments to establishing secure, efficient and cost-effective cross-border financial collateral arrangements. In short, the significant benefits for the financial markets in increased efficiency and legal certainty in relation to collateral markets will result in improving pricing efficiency in the market; deepening the market; expanding product, hedging and investment opportunities; reducing credit and systemic risk; and strengthening the financial system.

### **1. ISDA supports PRIMA and the continuing work of the Hague Conference on this issue**

As we have made clear in a number of fora over the past few years, ISDA members strongly support the view that, from both a theoretical and a practical perspective, the place of the relevant intermediary

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approach ("PRIMA") is the most sound basis for determining the law applicable to proprietary rights in indirectly held securities.

We acknowledge that the implementation of PRIMA in the proposed Convention and in national law raises certain points deserving of special consideration. In particular, Article 5 of the annotated July 2001 draft of the Convention raises some interesting and difficult questions on which we comment below.

We note that the draft also raises a number of issues and expressly defers them for further study and, in certain cases, market research. ISDA and its members will also continue to study, reflect and consult on these and related issues and to support the work of the Hague Conference.

## **2. ISDA sees no merit in the Super-PRIMA proposal**

The commentary on Article 2 of the annotated July 2001 draft of the Convention discusses a proposal by certain national experts that is referred to as "Super-PRIMA" in the text. Under this proposal, a single law would be chosen as the law applicable to a holding of securities at every level in a multi-tiered holding of those securities, regardless of how many tiers or jurisdictions are involved.

ISDA members see no merit in this proposal, which is not well-adapted to the complexity of modern indirect holding systems and suffers from many of the same draw-backs as the "look-through" approach discussed in the November 2000 Report of the Permanent Bureau on these issues. ISDA also agrees with the criticisms of "Super-PRIMA" suggested in the commentary on Article 2 in the annotated July 2001 draft of the Convention.

## **3. Article 5 of the draft Convention**

ISDA agrees that the determination of the place of the relevant intermediary is the key issue in the draft Convention. ISDA also believes that it is important to draft Article 5 in a manner that promotes the following fundamental objectives:

- provide *ex ante* certainty for financial market participants;
- be compatible with the realities of modern systems for holding and transferring book-entry securities;
- be compatible with a broad range of legal traditions.

Agreeing on a formulation that promotes all of these objectives, or that strikes the right balance among them to the extent they involve trade-offs, is the heart of the matter.

### *"Account approach" versus "Branch/office approach"*

The annotated July 2001 draft suggests two broad approaches to the drafting of Article 5 and then discusses different options under each. It also suggested that the branch/office approach may be superior to the account approach because of the practical difficulties of "ascribing a physical location for an account", which is essentially an intangible legal relationship. We acknowledge the difficulties of locating an account, particularly in a world in which the various functions involved in maintaining accounts may be dispersed among several jurisdictions.

Nevertheless, ISDA members believe that the account approach may have some advantages over the branch/office approach. For example, some members believe it is intuitively more consistent with the traditional *lex rei sitae* rule and therefore may result in a formulation that is more acceptable to a broader range of jurisdictions. We believe it is premature to limit discussion to one approach or the other.

### *Existing versus future securities custody arrangements*

We note that your commentary – quite rightly, in our view – is sensitive to the issue of providing legal certainty for existing as well as future securities custody arrangements. The ideal rule would provide certainty for both, without requiring a burdensome process of checking and/or (worse) amending existing agreements and without requiring onerous changes to the way securities account relationships are currently opened, maintained and documented. While not necessarily claiming to have achieved this in our proposals, we believe that this ideal should be kept in mind during further discussions on Article 5.

*ISDA proposals in relation to Article 5*

In keeping with the spirit of open enquiry and the proper consideration of all useful possibilities, ISDA has developed two alternative proposals, which we would like to submit for consideration. Please note, however, that each of these proposals, while favoured by some members of ISDA, remains under study by others. In addition, our goal in submitting this letter is not to close off discussion of any other formulation based on either the “branch/office approach” or the “account approach,” if another formulation would promote all of the fundamental objectives or strike a better balance among them. Instead, our goal is to propose a formulation that a substantial number of our members believe would strike an acceptable balance among the various fundamental objectives.

Proposal 1

Our first proposal is a development of the various options set out under the “account approach” in the annotated July 2001 draft of the Convention. It reads as follows:

- (1) **The place of the relevant intermediary is the place where the securities account with that intermediary is maintained.**
- (2) **For the purposes of this Convention, thesecurities account is maintained at the place of the office or branch of the relevant intermediary agreed between the account holder and the intermediary, provided that the [intermediary/intermediary's business] is subject to [regulation][regulatory supervision] in the place so agreed and that the maintenance of that securities account forms part of the intermediary’s business in that place.**
- (3) **If the place of the securities account cannot for any reason be determined under paragraph 2, a certificate issued by the relevant intermediary as to the place where the securities account is maintained is conclusive, provided that the relevant intermediary's business is subject to [regulation][regulatory supervision] in the place so agreed and that the maintenance of that securities account forms part of that business in that place.**
- (4) **If the place of the securities account cannot for any reason be determined under paragraphs 2 or 3, then the factors that may be considered in determining that place including the following:**

*[The text of sub-paragraphs (a) to (e) of Paragraph (3) of the annotated July draft to be inserted here]*

- (5) *[The text of Paragraph (4) of the annotated July draft to be inserted here]*

Paragraph (2), as in the case of Options A and B under “account approach” in the annotated July 2001 draft of the Convention, relies on the agreement between the account holder and the intermediary to determine the location of the account. The proviso to Option A, however, relies on the idea that the “maintenance of the securities account” is subject to regulatory supervision. Some ISDA members felt that it is the intermediary or the business of the intermediary that is subject to regulatory supervision (or regulation - as indicated above, there was some discussion of which is the more accurate term) rather than the maintenance, per se, of securities accounts. Also, some ISDA members felt that the proviso to Option A

does not necessarily ensure that the relevant securities account is actually located in the jurisdiction agreed between the account holder and the intermediary. (Other ISDA members, as noted above, consistently questioned whether it is possible to say that a securities account is "actually located" anywhere.)

We understand that those who believe that some sort of constraint or "reality check" (in the words of your commentary) should be imposed on the agreement between the account holder and the intermediary do not currently believe that the proviso to Option B under "account approach" in the annotated July 2001 draft of the Convention is sufficient. On the other hand, those who believe strongly in the value of *ex ante* certainty are not entirely comfortable with the level of due diligence that may be necessary to match an account with a particular part of an intermediary's business, as may be required by Proposal 1.

ISDA's first proposal attempts to deal with these concerns by focusing the proviso on the regulatory supervision (or regulation) of the intermediary's business, which seems to be a broadly acceptable formulation, while at the same time expressly tying the maintenance of the relevant securities account to the business of the intermediary regulated in that place.

We recognize that our formulation may reflect a trade-off between the fundamental objective of achieving *ex ante* certainty and the objective of making the formulation compatible with a broad range of legal traditions, including those with a commitment to the *lex rei sitae* principle. We believe, however, that it may represent an acceptable trade-off between these two worthy goals, subject to further discussion and study.

In relation to pre-existing account or custody agreements, we believe that "agreed" does not necessarily need to be read as an explicit reference to the location of an account in the account or custody agreement between the account holder and the intermediary. The agreement may be implicit, but nonetheless ascertainable on the basis of verifiable facts. Some of those facts may well be instances of the factors set out in sub-paragraphs (a) to (e) to Paragraph (3) the annotated July 2001 draft of the Convention. But other facts may also help establish the actual agreement of the parties in relation to the location of the account. An interpretative rule in relation to this point, as suggested in your commentary, is deserving of further consideration. As noted above, the ideal is to produce a rule that provides legal certainty for existing agreements without onerous due diligence or amendment.

Paragraph (3), which is a version of Option C under the "account approach", is another way of establishing *ex ante* certainty should Paragraph (2) fail to produce a clear result. The proviso is designed to prevent the intermediary from certifying an arbitrary location of the securities account and to permit a reading of the provision consistent with a more traditional approach to the *lex rei sitae* rule. The fact that the intermediary is a regulated institution should provide further comfort that it may not act in an arbitrary manner in relation to this certification.

As can be seen, we endorse the "cascade" approach of the annotated July 2001 draft of the Convention and agree that the remaining Paragraphs (numbered (4) and (5) in our first proposal) should only need to deal with a small number of cases.

## Proposal 2

Our second proposal follows the text of our first proposal, except that Paragraph (2) is amended to read in its entirety as follows:

- (2) **For purposes of this Convention, the securities account is maintained at the place of the office or branch of the relevant securities intermediary agreed between the account holder and the intermediary, provided that the intermediary is subject to, covenants to comply with, or does comply with, the duties of an intermediary with respect to the securities account and the account holder imposed by the laws of that place on intermediaries in the business of maintaining securities accounts in that place.**

This alternative version of Paragraph 2 prevents an agreement as to the account location from being effective for purposes of the Convention unless the intermediary acts or agrees to act in a way that is consistent with that agreement. For example, if the law of the agreed upon location requires intermediaries to have enough securities to satisfy the claims of all customers, to pass on the benefits of ownership to customers, or to record or report changes to the account in accordance with certain custody accounting rules, the intermediary would be required to comply or agree to comply with those requirements; otherwise, the agreement would not be determinative for purposes of the Convention. This approach may be superior to Proposal 1 in that it may impose a more potent constraint on the intermediary's behaviour, without undermining the goal of *ex ante* certainty.

#### 4. Other issues

We would like to make the following additional comments on the annotated July 2001 draft of the Convention:

- (1) The current draft, and the related commentary, posits a distinction between "pledges" on the one hand and "outright transfers" on the other hand. "Pledge" is defined to include a "title transfer by way of security". These distinctions, however, require careful handling, and we are not sure that the current draft of the Convention achieves the right balance. Under certain legal systems (for example, in the United Kingdom), a title transfer collateral arrangement is based on outright transfer. The fact that the commercial purpose may be to achieve an effect comparable to the creation of a security interest (for example, by way of mortgage of or charge on securities) is irrelevant. Such a transfer is a sale, and the transferee is a purchaser of the securities.

By contrast, in other jurisdictions, such as Italy, there is a middle category between a security interest, on the one hand, and an outright transfer on the other hand, namely, the irregular pledge. It achieves a transfer of title of the relevant collateral securities to the transferee, but is otherwise treated as a form of pledge for other purposes.

It is therefore questionable whether it is helpful to subsume title transfer "by way of security" under the definition of pledge, since it risks confusing the genuine outright transfer approach (on which the majority of cross-border title transfer arrangements in the European privately negotiated derivatives market are based, according to our own research) with the irregular pledge approach. By assimilating the title transfer approach to the security interest approach in the definition of "pledge", the Convention may perversely raise legal uncertainty by increasing recharacterisation risk in relation to title transfer collateral arrangements in some jurisdictions.

We note that the current draft EU directive on financial collateral arrangements uses separate definitions for "security financial collateral arrangement" and "title transfer collateral arrangement", and we would propose that a similar approach be taken in the Convention. Our suggestion would be to amend the definitions of "disposition" and "pledge" and to add a new definition of "title transfer collateral", along the following lines:

**"disposition" means pledge, title transfer collateral or outright transfer (sale);**

**"pledge" means any form of security interest, whether possessory or non-possessory;**

**"title transfer collateral" means a sale and repurchase agreement or other collateral arrangement based on transfer of title, whether by way of outright transfer (sale) or by way of security, including irregular pledge;**

It appears that no other changes would be necessary to the current draft of the Convention, as the term "pledge" is only used in the definition of "disposition". As you will see in the following comment, we are not in favour of the additional wording it is proposed to add to Article 4(1), but if that wording is added, then we would, of course, recommend amending the words to read "at the time of the pledge, title transfer collateral or outright sale transaction".

- (2) Regarding Article 4(1), ISDA endorses the current wording and agrees with the suggestion in the commentary that the inclusion of the words "at the time of the pledge or outright sale transaction" would not be helpful (possibly, in fact, the reverse).
- (3) Regarding Article 4(2)(e), it might be helpful to include the words "by an account holder" after the words "that intermediary", to make explicit that this provision refers to a third party claimant competing with an account holder in relation to securities held indirectly by that account holder.
- (4) Regarding Article 6(2)(a), we would recommend the inclusion of the words currently in square brackets.
- (5) We endorse Article 11 of the draft.
- (6) As noted above, the current draft of the Convention and the commentary leave a number of issues to be considered further. Where we have not expressly commented on a point, ISDA also reserves its position for further study, consultation and discussion among its members.

ISDA would like to reiterate its support for PRIMA and the work of the Hague Conference so far on these issues. We would be pleased to continue to work with the Permanent Bureau and other interested parties and would be happy to assist the work of the Permanent Bureau, for example, in relation to specific points of market practice that may help to inform the further development of the draft Convention. We also continue to work with other financial market trade associations and other interested bodies with a view to helping develop a market consensus on these and other legal issues affecting the legal certainty of modern cross-border financial collateral arrangements.

Yours faithfully,

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