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7 October 2005

BY E-MAIL AND BY POST

Department of Trade and Industry
Corporate Law and Governance
Bay 558, 1 Victoria Street
London SW1H 0ET

For the attention of: Anne Scrope

companylawreform@dti.gsi.gov.uk

Dear Sirs,

The Registration of Companies' Security Interests (Company Charges)

We are grateful for the opportunity to comment on your Consultation Document on the Economic Impact of the Law Commissions' Proposals on the Registration of Companies' Security Interests (Company Charges) of July 2005. We have followed with interest prior consultations by the Department of Trade and Industry and by the Law Commission concerning registration of charges and other issues relating to personal property security interests.

We have had the opportunity to participate in consultation meetings held by the Law Commission, and we commented on the Law Commission's Consultative Report (Consultation Paper No. 176): Company Security Interests in our letter of 23 November 2004 to the Law Commission.¹ In that letter, we commended the Law Commission on the high quality of its work on the law relating to personal property security interests, the openness and comprehensiveness of its consultation process, the thoroughness of its preparation and the detail of its proposals. We also raised various concerns about its proposals, some of which have been addressed by the revised version of the proposals which appears in the Law Commission Report, *Company*

¹ A copy of this letter is available from our website at <http://www.isda.org>.

Security Interests (Law Com No 296), which was published on 31 August 2005 and which is reflected in the draft Company Security Regulations 2006 (the **Draft Regulations**), which were annexed both to your Consultation Document and the Law Commission Report.

The International Swaps and Derivatives Association, Inc. (ISDA) is the global trade association representing leading participants in the privately negotiated derivatives industry, a business which includes interest rate, currency, commodity, credit and equity swaps, options and forwards, as well as related products such as caps, collars, floors and swaptions.²

We have a particular interest in these proposals as a significant proportion of financial collateral arrangements entered into in the European financial markets are documented using ISDA standard form credit support documents governed by English law. More generally, one of our core missions is to promote measures to strengthen legal certainty in the financial markets. To this end, ISDA and its members have devoted significant resources to promoting financial law reform, with particular attention to strengthening close-out netting and the legal framework for financial collateral arrangements.

We acknowledge that the Law Commission proposals go beyond our area of concern and expertise, namely, the professional or wholesale financial markets. Accordingly, we focus our comments primarily on the provisions dealing with financial collateral and certain other provisions with a potential impact on close-out netting and contractual set-off, both of which are extremely important for the reduction of credit risk and settlement risk in the financial markets.

In responding to the Consultative Document, we defer to national legal experts in the United Kingdom as to the technical detail of the proposed regime and its impact upon existing law. We note that a number of our legally qualified members have been involved in other more detailed responses to your Consultation Document. In particular, a number of them have been involved in the preparation of the response of the Financial Law Committee of the City of London Law Society (the **CLLS**) to the Consultation Document. We agree with and support the conclusions of the CLLS to the extent that they relate to financial collateral and other issues potentially affecting wholesale financial market transactions.

We would like to take this opportunity to answer some of the questions posed in the Consultation Document, highlighting a few issues of particular concern to us.

Options

The Consultation Document sets out three options. We favour the proposals of the CLLS, which would involve relatively small changes to make the existing system work better in certain respects and would clarify certain areas of uncertainty in relation to the current regime.

² Additional information on ISDA is available from our website at <http://www.isda.org>. Nearly half of ISDA's members are European institutions and more than half of its current Board members represent European institutions, including three major British banks. Virtually all of its members have significant operations in the City of London or important dealings with London-based financial market participants.

Priority rules

We share the concerns raised by the CLLS in relation to the proposed priority rules.

Financial collateral

We support in principle the Law Commission's proposal for clarification of the concept of "control" in relation to the regime for financial collateral arrangements established by the Financial Collateral Arrangements (No. 2) Regulations 2003. We note that the CLLS has offered some preliminary comments on draft regulation 40, and we may comment further in this regard if it is decided to proceed with the Draft Regulations.

Recharacterisation risk

As we stressed in our letter to the Law Commission of 23 November 2004, English law is widely used in the financial world because there is a strong perception that it is stable and predictable and that the English courts favour freedom of contract. Recharacterisation risk is not presently perceived to be an issue, in contrast to the position, for example, under the laws of a number of other jurisdictions.

In this regard, we are pleased to see that the wholesale inclusion of "quasi-security" within the Law Commission's scheme has been omitted from the current proposals along with the proposed statement of rights and remedies. The introduction of recharacterisation risk in relation to title transfer financial collateral arrangements would be inconsistent with the obligations of the UK under the European Directive on financial collateral arrangements³ and would reduce the attractiveness of English law as a basis for this form of collateral arrangement, the most widely used in the European market for privately negotiated derivatives.

We note and support the CLLS proposal that the sale of receivables should be excluded from scope of the Draft Regulations. However, if this proposal is not accepted, we believe that the Draft Regulations should be clarified to eliminate any doubt that amounts due under contracts relating to wholesale financial market transactions, including physically-settled securities- and commodities-related derivatives transactions, are not receivables. This is particularly important in relation to our next point.

Prohibition of assignment of "receivables" – potential impact on close-out netting and set-off

While we understand the rationale of the proposed statutory invalidation of contractual provisions prohibiting or restricting assignment of receivables, it must be absolutely clear that an amount due under a financial contract is not a receivable for the purposes of the proposed prohibition (draft regulation 35(5)). It is critical to effective credit risk management that a party is able to control both its exposure and its liability to each counterparty. If the benefit of a bank's obligation to its counterparty could be freely assigned by the counterparty without the bank's consent, the bank could not effectively monitor its net exposure. Thus the operation of

³ Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

close-out netting provisions or contractual set-off provisions as a means of reducing credit risk would potentially be comprised.

Much of modern financial practice is concerned with measuring, monitoring and managing credit risk, and this is, of course, of increasing importance to the prudential supervisory regime for regulated institutions. A financial institution's ability to control credit risk via appropriate contractual arrangements should not be impaired by the application of a rule of the type set out in draft regulation 35(5). We do not believe that this is the intention of the proposal, but we think that this needs to be made clearer than it is in the Draft Regulations.

Also, a regulated financial institution should not find itself involuntarily in a contractual or commercial relationship with a party, in relation to whom it has not had the opportunity to effect its client or counterparty identification procedures. These procedures are increasingly important, for various reasons, to the regulatory regime for financial institutions, for example, to comply with "know your customer" rules and in relation to money laundering.

Charge-backs and cash collateral

We support draft Regulation 44, which provides helpful clarification in sub-clause (2) that charge-backs in relation to bilateral cash collateral arrangements are effective.

We would be pleased to discuss any of these issues with you in more detail if you would find that helpful. If so, please do not hesitate to contact either of the undersigned.

Your faithfully,

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