

ISDA

International Swaps and Derivatives Association, Inc.
One New Change
London EC4M 9QQ
United Kingdom
Telephone: 44 (20) 7330 3550
Facsimile: 44 (20) 7330 3555
email: isdaeurope@isda.org
website: www.isda.org

28 February 2005

Ignacio Gómez-Sancha
European Capital Markets Institute
Plaza de la Lealtad 1
28014 Madrid
Spain

Dear Sir:

We refer to your letter of 3 February 2005 regarding the research project commissioned by the European Capital Markets Institute on the potential impact of the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary (the "Convention"). ISDA actively participated in the public consultations leading to the adoption of the Convention, both with attendance at various Convention drafting sessions and through consultation with its wide range of global members.

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 a range of products, such as interest rate, currency, commodity, credit and equity derivatives. Promoting the enhancement through law reform of legal certainty for cross-border financial transactions is one of ISDA's key missions. A considerable proportion of ISDA's resources and its members are devoted to acquiring legal opinions from over 45 jurisdictions on netting and collateral arrangements, promoting law reform and participating in consultations on legislative and regulatory developments affecting the financial markets. The largest group of ISDA members, by geographic region, is the European membership and this is reflected in the composition of ISDA's Board of Directors. Additional information on ISDA, its membership and its interest in and commitment to the development of international law affecting the financial markets is available at www.isda.org.

In general, ISDA believes that the Convention represents a careful balance of the fundamental objectives of:

- *ex ante* certainty for financial market participants achieved by clearly defining and simplifying the conflict of laws rules for dispositions of securities held in book-entry form by financial intermediaries;

- compatibility with the current developments in technology and the realities of modern systems for holding and transferring book-entry securities; and
- compatibility with a broad range of legal traditions.

While this comment letter will not reply to each specific query set forth in your letter, the broad themes discussed in your letter will be responded to below.

PRIMA and Relationship with the Settlement Finality Directive and the Financial Collateral Directive

In response to your statement in Paragraph 2.1 regarding the assertion that the Convention approach is not compatible with the PRIMA approach as implemented in existing EU legislation and the statement in the introductory text that "... in the final months of its drafting process the Convention made a 180° turn ...", ISDA would not necessarily agree with this characterization, believing the analysis to be more nuanced. During the preparation of the Convention, the international financial community was widely consulted and was clear in its consensus view that the "place of the relevant intermediary approach" or "PRIMA" was the correct approach to determining the law applicable to interests in securities held with an intermediary. The evolution of PRIMA is explained at length in the Explanatory Report.¹

PRIMA is reflected in the approach taken in Article 9(2) of the Settlement Finality Directive (the "SFD") and Article 9 of the Financial Collateral Directive (the "FCD"). These two Directives are beneficial interim measures for the European financial markets. However, their approach is inadequate as a long-term measure, as their respective provisions are vague and broad. It is true that the Convention moves beyond the initial formulation of the PRIMA principle as reflected in the SFD and the FCD in the narrow sense of moving away from geographical place as a primary element of the test. The Convention focuses the test on the relationship with the account holder's intermediary.

It is uncontroversial that the Convention involves some changes in existing European Union measures, in particular, Article 9(2) of the SFD and Article 9 of the FCD. EU Member States were mindful of this when, as Hague Member States, they agreed the text of the Convention and concluded that it represented an improvement to the current position that was necessary for further strengthening of the European financial markets. To the extent that the term "PRIMA" suggests that place or location is a primary element of the rule, then PRIMA is probably not an appropriate acronym by which to designate the rule in the Convention, although this concept is relevant to some aspects of the rule. It has been suggested by some that "RIMA" (relevant intermediary approach) or "LIMA" (the law of the intermediary account agreement) would be more appropriate acronyms in light of the fact that the account holder's relationship with its intermediary is central to the Convention's rule.² To harmonize the use of the term "PRIMA",

¹ It is worth noting that the rapporteurs responsible for preparing the Explanatory Report were three leading experts in the private international law of finance. Two rapporteurs were from European jurisdictions and two were from civil law jurisdictions. This is strong evidence that European views, in particular, civil law views, were fully considered in the formulation of the Explanatory Report and in contributions to the Convention itself.

² There is a clear and detailed exposition in the Explanatory Report regarding the significance of Articles 4 and 5 of the Convention.

the European Commission has indicated that it may be willing to alter the SFD and CFD in order to bring those Directives into line with the conflicts of law provisions of the Hague Convention. The Explanatory Report offers a thorough analysis of these concepts and ISDA recommends the document to you.

SFD and Settlement Finality Risk

Paragraph 9 of your letter raises a possible concern that the Convention could interfere more generally with the operation of the SFD by permitting a situation in which different securities accounts with the same intermediary were governed by different substantive laws. It is our view that this scenario is unlikely to occur in any settlement system, but that in any event it could not occur in a system designated under the SFD since the conditions for designation include the requirement that the system be governed by the law of a particular EU Member State. Even if this were not the case, both the designating authority and the European Central Bank (in the case of a system used to deliver central bank collateral in the Eurosystem) will have the power to impose whatever conditions they may regard as appropriate on systemic grounds.

Legal Certainty and Transparency

In response to Paragraphs 4 and 5 of your letter, the text implies that existing transparency could be endangered and that the Convention only achieves legal certainty for the intermediary and the account holder. A majority of ISDA's members would not agree with this characterization, particularly given the broad and open consultative process that led to the adoption of the Convention. The purpose of the Convention is to achieve legal certainty as to the law applicable to govern certain rights in securities for all relevant parties. In addition, the Convention enhances transparency, whereas the current state of law across Europe creates greater uncertainty as to the relevant conflicts of law rules in many jurisdictions.

With respect to legal certainty, Articles 4 and 5 of the Convention point to a single applicable law to govern certain rights in securities in virtually all cases. This certainty benefits all persons with an actual or prospective interest in the securities.

With respect to transparency, in the context of private accounts, even under existing rules, the account holder and its intermediary will inevitably have the best information regarding the holder's account, including where it is maintained. A third party proposing to assert an interest in or claim against securities recorded in an account maintained for an account holder will need to know of the existence of the account, the identity of the intermediary and, presumably, details of the securities held with the intermediary and request such information from the account holder or its intermediary (providing that bank secrecy laws do not prevent the intermediary from providing the information). That position is not altered by the Convention. It should also be considered that securities intermediaries are professional and responsible parties, licensed and subject to prudential regulation as to the conduct of their business.

Common Law or U.S. Model

In Paragraph 20.1 of your letter, the assumption set forth could be characterized as an assertion that the Convention was primarily designed for systems following the U.S. model, or at least a common law model. As anyone involved in the drafting efforts can attest, the drafting group took significant steps to ensure that the approach was as neutral as possible between different

legal and conceptual structures. One of the many signs that there was no bias in the process is that no one from the U.S. was involved in the preparation of the Explanatory Report.

Notwithstanding this, it appears to have been suggested that the Convention rules set out in Articles 4 and 5 would make it easier for a U.S. customer to impose its domestic law on a European custodian. A majority of ISDA's members do not believe this is accurate. If it were true, however, then presumably the converse would also be true, namely, that a European customer could impose its domestic law on a U.S. custodian. Greater choice and freedom for customers is not a bad thing. Under the current approach, a customer may insist upon its domestic law applying if it wishes to do so simply by insisting that a global intermediary open in their enhanced systems an account for it in its home jurisdiction. If a particular global intermediary is unwilling to do that, the customer, whether it is European, American or other, will normally have a choice of other intermediaries who would be willing and able to open an account for it in its home jurisdiction. The enhanced certainty created by the Convention will make it easier for a customer from any future Convention Member State dealing with an intermediary from another Convention Member State to open an account governed by an agreed foreign law, since the customer, on the basis of the Convention, will be able to determine with certainty which law will apply to certain rights in the securities in its account and to investigate with confidence the legal and regulatory framework that will apply.

Endorsement of the Convention

A number of international groups studying the international financial markets, including the Forum Group on Collateral established by the European Commission in 2001, and the Giovanni Group, have issued statements of support for the Convention. In addition, the European Commission has publicly stated on several occasions its support for the Convention. The majority of ISDA's membership believes that it is in the interests of the European financial markets that the Convention rule be established as widely as possible internationally, replacing the myriad of different and inconsistent rules currently followed by jurisdictions around the world and eliminating the associated legal uncertainty. In addition, the Convention is critical as it relates to Basel II's requirement for legal certainty with respect to collateral arrangements.

In the event you would like to discuss any matters further, please do not hesitate to contact me at your convenience.

Thank you in advance for your consideration.

Sincerely,

Kimberly Summe

Kimberly Summe
General Counsel
(ksumme@isda.org)

Dr. Peter Werner
Policy Director
(pwerner@isda.org)