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Mr Dan Lambeth
HM Treasury
Financial Stability & Regulatory Policy
1 Horse Guards Road
London SW1A 2HQ

Dear Mr Lambeth,

Directive on Financial Collateral Arrangements

Thank you for your letter of 3rd April, 2003 and your kind invitation to comment on the paper “Directive on Financial Collateral Arrangements: Initial Policy and Legal Questions”, which was enclosed with the letter. We have noted that the paper is for comment and discussion only and does not represent UK Government policy.

The International Swaps and Derivatives Association (ISDA) has long supported collateral law reform to enhance legal certainty and the efficient use of collateral in the international financial markets, including, in particular, of course, the market for privately negotiated derivatives. In early 1999, we established our Collateral Law Reform Group (chaired by Edward Murray, Allen & Overy) to study the various problems and uncertainties hindering the development of cross border collateral arrangements, focusing initially on the European Union.¹ We urged the European Commission to include collateral law reform as a key objective during the consultation leading to its Financial Services Action Plan in 2000, and active members of our Collateral Law Reform Group were among the national experts asked to participate in the Commission’s Forum Group on Collateral. We closely followed the development of, and actively participated in the consultations on, the Directive on financial collateral arrangements (the *Directive*), and we are monitoring its implementation across the European Union. We were also actively involved, from its inception, in the work leading to the adoption in December 2002 of the Hague Convention on the law applicable to certain rights in respect of securities held with an intermediary (the *Hague Convention*). ISDA has always supported what is generally referred to as the “place of the relevant intermediary” or *PRIMA* approach to the choice of law applicable to proprietary issues affecting indirectly held securities

¹ See, for example, the ISDA Collateral Law Reform Group paper “Collateral Arrangements in the European Financial Markets: The Need for National Law Reform”, March 2000, available from our website at <http://www.isda.org> (under “Publications – ISDA Credit Support Documentation, User’s Guides and Guidelines”).

Enhancing legal certainty is one of ISDA's key missions. In 1987, ISDA began collecting netting opinions and in 1998 collateral opinions. To date, ISDA has netting opinions from nearly 40 jurisdictions and collateral opinions from over 30 jurisdictions. ISDA also has obtained opinions on other legal issues of importance to its members.²

We are therefore particularly pleased to be invited to comment on your paper. We comment below on the points raised and questions posed in your paper following the order and headings of the paper. Although, as noted above, ISDA has been active in obtaining legal opinions from local counsel in various jurisdictions on close-out netting and collateral, it does not itself offer legal advice to its members or others. The views expressed below on points of UK law (acknowledging that there are separate legal systems in England and Wales, Scotland, and Northern Ireland) are based on a general understanding of the position and are not intended as legal advice.

1. Overall approach

ISDA fully supports the approach suggested in the paper. In particular:

- to extend the scope and usefulness of financial collateral arrangements (*FCAs*) as widely as possible
- to have a clear and effective legal framework, and
- to avoid unnecessary statutory amendments (as these may, inadvertently, lead to new uncertainties).

2. Article 1 – persons within scope of implementation

During the consultative process, ISDA urged the European Council and the European Parliament to implement the Directive on the widest possible basis. We do not think that it is in the interests of any market participant, whether as likely collateral provider or likely collateral taker, as dealer or end-user, to be excluded from the greater certainty and therefore efficiency that the Directive is intended to apply.

We believe that the opt-out in the Article 1(3) of the Directive was included for reasons that were not fully considered, and we are urging all Member States not to exercise it.

Although ISDA's mission is to the inter-professional and wholesale financial markets and not the retail financial markets, we can see no policy reason why individual natural persons should be excluded from its scope.

3. Article 1 – collateral within scope of implementation

We agree with the suggestion in the paper that there is no need for the UK to exercise the opt-out in Article 1(4)(b) of the Directive.

4. Article 3 - formal requirements

As far as we are aware, the registration of charges regime for companies in Part XII of the Companies Act 1985 is the only registration or procedural formality generally applicable to charges granted by financial institutions and companies that would need to be disappplied to FCAs.

5. Article 4 – enforcement by appropriation

We understand that the current restriction in UK law on a mortgagee appropriating mortgaged property by requiring it to obtain a court order if it wishes to do so is a heavy-handed way of enforcing the general self-dealing rule applicable to mortgagees. The policy basis underlying this requirement is not relevant to modern financial markets, where the vast majority of collateral used is liquid and easy to value by reference to market prices.

² For example, on the effectiveness under English and New York law of its various Protocols on the introduction of the euro.

It should therefore be possible to rely on the general duty of a mortgagee or other secured party to obtain a reasonable price for the collateral realised, without putting it to the expense and uncertainty of obtaining a court order. This would also avoid the need for corporate mortgagees to make artificial intragroup sales of collateral (subject always to the duty to obtain a reasonable price) simply to avoid the requirement of a court order.

6. Articles 4 and 7 – administration

Our understanding is that the current stay on proceedings upon petition for or the making of an administration order does not prevent close-out netting or the exercise of rights of set-off. Therefore a title transfer FCA should not be affected by the administration stay or freeze. This is subject to the caveat mentioned in the paper in relation to the new rules applicable to insurance companies, which appears to warrant further study.

We agree that the administration stay or freeze would need to be disapplied in relation to FCAs based on enforcement of a security interest. We believe that this is sensible from a policy point of view (and eliminates the need to choose a title transfer FCA over a security FCA for this reason alone).

7. Article 5 – right of use

We understand that, although it is possible to include a right of use under an English law governed security FCA (and we imagine that the position might be similar in Scotland and Northern Ireland), this potentially leads to uncertainty as to whether the security FCA should, in fact, be characterised as a title transfer FCA. The concern is that the ability of a collateral taker to deal with the collateral as though it is the owner is inconsistent with the limited proprietary nature of a security interest.

We note that a number of European member states are most troubled by the conceptual difficulty this raises for the implementation of this aspect of the Directive. Under an English law security FCA, we understand that, where a collateral taker is empowered to dispose of the entire property, the normal effect (subject to drafting of the relevant FCA) would be to give rise to a conditional obligation of the collateral taker to return fungible equivalent collateral, and this obligation would be discharged by netting or set-off against the collateralised obligations in the event of a default by the collateral provider. Hence, a security FCA with a right of use would function in the same way as a title transfer FCA.

Thus, parties using English law governed FCAs tend to opt for the simplicity of a title transfer FCA (at least where the collateral taker is likely to want to sell, repo out or otherwise use the collateral) over the artificiality of a security FCA with a right of use. Security FCAs would tend to be reserved for special cases, where a right of use is not important commercially but, for example, preserving the proprietary interest of the collateral provider in the original collateral is important.

Based on the foregoing, it does not appear to be the case that the law needs to be changed to clarify that a security FCA may include a right of use, although for the reasons given above and immediately below some clarification of the effect of such an inclusion might be helpful.

The only aspect of the current law affecting security FCAs including a right of use that appears to need clarifying is the concern that the inclusion of a right of use would constitute a “clog on the equity of redemption”. We understand that the better view of the current law is that a right of use in a security FCA would not be interpreted as constituting a clog, but would instead be analysed along the lines suggested above. But some commentators are concerned about the clog issue, and it might be helpful to put this concern to rest.

8. Article 6 – no recharacterisation

We believe that it is well-established that there is no significant risk of recharacterisation of a title transfer FCA as a security FCA. In light of your suggested policy objective of making only necessary statutory changes, we would counsel caution. This is particularly so if the effect of such a clarification were, by negative implication, to raise recharacterisation doubt about other “true sale” arrangements (which are common in various parts of the financial markets – for example, securitisations, repos and sale/leasebacks) falling outside the specific statutory regime for FCAs.

9. Article 7 – recognition of close-out netting provisions

Regarding Article 7(1)(a), the current UK regime for close-out netting is one of the strongest in the world, and so once again your policy of making only necessary statutory changes suggests caution. We note, however, that the new rules relating to insurance companies bear careful study. Apart from that example, we would need to study any proposal carefully with a view to ensuring that it did not raise inadvertently any new issues or uncertainties.

Regarding Article 7(1)(b), we understand that the current position under UK law provides effective protection for a collateral taker from third parties attempting to claim rights to collateral held by the collateral taker, broadly speaking, where the collateral taker has no notice of the third party’s claim prior to entering into the FCA and related collateralised transactions. There is, of course, always some uncertainty at the margins as to what constitutes notice for these purposes, but we are not sure that those uncertainties could be easily eliminated by statute.

We do not believe that anything needs to be done to implement Article 7(2) in the UK.

10. Article 8

We do not believe that any change to current UK law to implement Article 8. As we understand it, section 127 of the Insolvency Act 1986 currently only applies to post-petition disposals.

We agree that the current UK rules relating to preferences, transactions at an undervalue and transactions defrauding creditors are not inconsistent with Article 8, and we do not therefore believe that any change needs to be made in this regard.

11. Article 9 – choice of law and the Hague Convention

We are aware of the current plans to introduce an amending Directive to amend Article 9 of the Directive to bring it in line with the Hague Convention. While we always understood that Article 9 of the Directive was intended to be consistent with the Hague Convention, we understand that there are concerns that the final text of the Hague Convention (in particular, Articles 4, 5 and 6) are sufficiently different from the current wording of Article 9 that even on a purposive reading of Article 9, there is a risk that member states might implement Article 9 on a basis inconsistent with the Hague Convention.

We have always supported what is generally referred to as the “place of the relevant intermediary” or *PRIMA* approach to the choice of law applicable to proprietary issues affecting indirectly held securities. We have, in particular, supported the Hague Convention from the outset of the project, and we believe that it is in the interests of the global financial community for the Hague Convention to be signed and implemented by as many countries as possible, including, in particular, the member states of the European Union.

We have already discussed with the European Commission its plans in relation to an amending Directive and, while sympathetic to the need, expressed our strong view that this should not delay or risk delaying implementation of the Directive.

Once again, we thank you for the opportunity to comment on the questions raised in your paper. If you would like to discuss any of the issues in this paper, please do not hesitate to contact the undersigned. If we can assist in any other way, for example, by providing you with further information about market practice on any point, please do not hesitate to contact us.

Yours sincerely,

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