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10th October, 2003

Financial Collateral Directive Consultation
Financial Stability and Regulatory Policy Team
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

Dear Sirs

Consultation on Implementing the Financial Collateral Directive (2002/47/EC) in the United Kingdom

Thank you for your letter of 30th July, 2003 and your kind invitation to comment on your consultation document "Implementation of the Directive on Financial Collateral Arrangements" (July 2003), a copy of which was enclosed with the letter, and which included as Annex A draft regulations to implement the Directive (2002/47/EC) on financial collateral arrangements (the *Directive*) in the United Kingdom and as Annex B a partial Regulatory Impact Assessment.

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 interest rate, currency, commodity, credit, and equity swaps, options, and forwards, as well as related products such as caps, collars, floors, and swaptions. Additional information on ISDA, its European membership and its interest in the development of European and UK law affecting the financial markets is set out in the Annex to this letter.

ISDA has actively supported collateral law reform in Europe for many years and participated, along with other leading financial market associations, including the British Bankers Association, the London Investment Banking Association, in the various public consultations leading to the adoption of the Directive. ISDA has been actively monitoring the progress of implementation of the Directive in each Member State of the European Union.¹ ISDA also participated actively in the public consultations leading to the adoption by the Hague Conference on Private International Law of the Hague Convention on the law applicable to certain rights in respect of securities held by an intermediary, signed in December 2002.

¹ A summary of publicly available information on implementation of the Collateral Directive in each Member State is regularly posted and updated on ISDA's website at <http://www.isda.org> (see "Committees", then "Collateral Law Reform Group", where there is a hyperlink to the summary at the end of the second paragraph).

Promoting legal certainty for cross-border financial transactions through law reform is one of ISDA's key objectives. A considerable proportion of the resources of ISDA and its members is devoted to acquiring and updating legal opinions from a wide range of jurisdictions on netting, set-off and financial collateral arrangements.

Before turning to your specific questions raised in the consultation document, we would make the following observations:

- Various questions you raise concern general market practice in relation to financial collateral arrangements as well as related costs and other practical issues. In this respect, you should note that ISDA has an active Collateral Committee (of which our Collateral Law Reform Group is a sub-committee), which is primarily composed of collateral managers at a number of ISDA's primary members. Much of the work of this Committee has been published in various forms. You may find particularly helpful on questions relating to market practice, operations, and costs ISDA's annual Margin Surveys, which have been compiled annually since 1999.
- Although, as noted above, ISDA has been active in obtaining legal opinions from various jurisdictions on collateral arrangements, ISDA as a trade association does not offer legal advice to its members or to others. The views expressed below, to the extent that they touch on questions 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 offered as definitive views on those legal questions. We focus, accordingly, on the policy questions raised in the consultation document and leave detailed commentary on technical legal and drafting issues to national legal experts in the UK.

We now turn to your specific questions:

Question 1: Do you support the extension of the scope of the implementation to cover all financial collateral arrangements as between two corporate bodies where one is not a financial institution? Would you support the further extension to include arrangements involving natural persons?

ISDA and its members strongly support the broadest possible scope of implementation for this Directive. One of the principal benefits of the Directive is the promotion of legal certainty by requiring member states to simplify and rationalise the requirements for the creation, perfection, and enforcement of financial collateral arrangements.

Legal certainty is of equal value to all users of financial collateral, whether they are providers or takers of financial collateral. In fact, a large proportion of cross-border financial collateral arrangements entered into in connection with a master agreement (such as the 1992 or 2002 version of the ISDA Master Agreement) are bilateral. This means that a party to the arrangement may be at times a provider of collateral and at other times a taker of collateral, according to the evolution of the net exposure under the master agreement.

We can see no policy justification for denying the benefits of the Directive to corporate end-users of financial services, whether they are taking or providing financial collateral. Given the importance of corporate end-users to the health of the market as a whole, a considerable part of the beneficial effect of the Directive would be lost if corporate end-users were excluded. Banks and companies would both be hurt. Banks would suffer because they would continue to suffer the legal risk and uncertainty associated with financial collateral arrangements under the current legal framework when dealing with corporate customers under UK law. British companies would suffer because they would be restricted or even excluded from access to financial services at the more favourable pricing available where financial collateral is provided.

Accordingly, we support the approach taken in the current draft regulations of not exercising the opt-out under Article 1(3) of the Directive to exclude corporate bodies from the scope of the implementation. We also support, for the reasons given above, the broader implementation discussed in paragraph 2.3 of the consultation document.

As our mission as a trade association concerns the wholesale financial markets, we have no official comment on your question concerning the extension of the benefit of the new regime to natural persons. We note, however, your comment in paragraph 2.2 of the consultation document to the effect that many of the Directive's provisions already apply under UK law irrespective of the identity or capacity of the parties.

Question 2: Should the definition of "cash" include a sum due or payable in connection with the operation of a close-out netting provision?

For clarity and comprehensiveness, and therefore legal certainty, we support the proposed inclusion in the definition of "cash" of a sum due or payable in connection with the operation of a close-out netting provision. Security financial collateral arrangements, particularly in the context of acquisition, project and structured financings, often include security over any amount that might be due under the close-out provisions of a master agreement entered into to hedge the financing. It would be helpful to have this clearly included within the protection offered by the new regime.

In the case of title transfer financial collateral arrangements, the close-out amount would normally be clearly covered by the arrangement as a matter of course, either by reflecting the financial collateral values transferred under the arrangement as part of the close-out calculation (as, for example, in the case of the 1995 ISDA Credit Support Annex under English law or Part 3 of the 2001 ISDA Margin Provisions) or by virtue of a broad contractual set-off provision that would include relevant payment obligations (including the close-out amount) regardless of whether they would otherwise commercially be considered to be "cash" obligations.

Question 3: Do you agree that, in the interests of protecting third parties, the regulations should only apply to floating charges where both:

- (a) the charge has crystallized; and**
- (b) some element or designation of possession or control of the collateral assets has passed to the collateral taker?**

A security financial collateral arrangement entered into under the 1995 ISDA Credit Support Deed (the *Deed*) would normally be expected to be a fixed charge, although we understand that whether or not the Deed (or any other security document) would constitute a fixed or a floating charge would depend on an analysis of its substantive effect. We are not certain, in any event, whether (a) should be required as long as (b) is satisfied. But this is a technical issue, on which we would defer to the judgement of national legal experts in the UK.

Question 4: Do you agree that the draft regulations remove requirements for all the formalities which are realistically likely to impact upon the creation and perfection of financial collateral arrangements?

We are not aware of any formal requirements likely to impact upon the creation and perfection of financial collateral arrangements that are not referred to in the draft regulations. We believe, however, that it would be better for the draft regulations to include a generic disapplication of formal requirements likely to impact upon the creation and perfection of financial collateral arrangements, and then cite the specific examples of legislation referred to in the draft regulations as included, without limitation, within the effect of the generic disapplication.

We suggest that it would be clearer to disapply the whole of Part XII of the Companies Act 1985 in relation to financial collateral arrangements, rather than simply disapplying sections 395 and 410 (and comparably amending the Companies (Northern Ireland) Order 1986).

Question 5: Do you agree with our analysis regarding the impact of Article 8(1) on section 245 of the Insolvency Act 1986?

While we defer to national legal experts in the UK in relation to this question as a technical matter, the analysis of the impact of Article 8(1) in the consultation document accords with our understanding of the current position in the UK in relation to the matters discussed in paragraphs 5.11 - 5.13 of the consultation document. It is our understanding that Article 8 of the Directive was not intended to disapply rules relating to preferences, transactions defrauding creditors and the like, other than where those rules are applied mechanically on the "sole basis" that the financial collateral arrangement has come into existence or a collateral transfer has been made during a suspect period.

Question 6: Do you agree with our analysis regarding the impact of Article 8(3)(ii) on section 245 of the Insolvency Act 1986?

We defer to national legal experts in the UK in relation to this question. As noted above, parties would normally seek to create a fixed rather than a floating charge in relation to financial collateral entered into in connection with an ISDA Master Agreement, but to the extent that such an arrangement might be characterised as a floating charge, it would appear beneficial to disapply section 245 of the Insolvency Act 1986. The other rules mentioned in paragraph 5.13 of the consultation document would remain applicable, where relevant, to protect against abuses.

Partial Regulatory Impact Assessment and questions 7 to 11 of the consultation document:

In relation to the Partial Regulatory Impact Assessment and questions 7 -11 of the consultation document, you may find it useful to review the 2003 Margin Survey published by ISDA and available, as noted above, from our website at <http://www.isda.org>, where you will also find other materials that may be useful in your consideration of these questions. We are in broad agreement with the general conclusions expressed in the Partial Regulatory Impact Assessment in terms of the benefits of the Directive for businesses in the UK (and, of course, elsewhere in the European Union).

In paragraphs 11 and 12, you refer to the informal consultation on the Directive in relation to which we were pleased to participate and to your intention to consult on the effects of the Directive three years after its implementation. We would be pleased to participate in that and any future consultation on these important issues.

Other comments on the consultation document and the draft regulations**(1) *Rule 4.91 of the Insolvency Rules 1986***

In relation to regulation 14, we have always understood that rule 4.91 of the Insolvency Rules 1986 does not interfere with the contractual close-out netting mechanism of a master agreement such as the ISDA Master Agreement, but simply provides that a claim for the resulting close-out amount against an English company in liquidation would need to be converted to sterling for purposes of proving the debt in the liquidation proceedings. While it would be useful to clarify (to the extent that there might be some remote theoretical doubt on the point) that rule 4.91 is not intended to govern internal foreign exchange conversions within a close-out calculation, we see no reason in principle why net debts relating to financial collateral arrangements should not otherwise be subject to rule 4.91. In other words, we wonder whether as currently drafted regulation 14 is unintentionally broad. We can see the pragmatic and policy basis, to ensure equal treatment of all creditors, for providing that all debts subject to proof in the winding up of an English company should be denominated in a single currency.

(2) *Conflict of laws*

We participated in the consultative process that led to the formulation and signature of the Hague Convention. We strongly support the objective of legal certainty in relation to conflict of laws rules applicable to transfers of financial collateral and in particular endorse the so-called PRIMA ("place of the relevant intermediary approach") rule exemplified in Article 9 of the Directive and in the Hague Convention. We believe there is a danger of inconsistencies developing at national level in the formulation of the PRIMA rule,² and we therefore support the long-term convergence of such rules on the approach set out in the Hague Convention.

(3) *Security financial collateral arrangements entered into prior to the effective date of the proposed regulations*

The draft regulations should clarify that security financial collateral arrangements entered into prior to the effective date of the proposed regulations nonetheless benefit from the greater certainty and clarity that the regulations will bring to such arrangements.

As you will be aware from the various UK government consultations over the years on the registration of charges regime under Part XII of the Companies Act 1985 (the most recent such consultation currently being conducted by the Law Commission), many security financial collateral arrangements have been subject to some doubt because of uncertainty with regard to (a) what constitutes a "book debt" for purposes of section 396 of the Companies Act 1985 and (b) whether a right of substitution of collateral included in a security financial collateral arrangement (regarding which, see also the next comment) would cause the arrangement to be characterised as a "floating charge" for purposes of section 396. Since for compelling practical reasons only a relatively small proportion of security financial collateral arrangements have been registered under the Companies Act 1985 (and even then generally only out of an excess of caution), it would be a valuable strengthening of legal certainty in relation to those arrangements for the regulations expressly to eliminate any theoretical doubt that may persist on the registration question.

(4) *Security financial collateral arrangements and rights of substitution*

It is a common and commercially important feature of financial collateral arrangements, both those based on creation of security and those based on title transfer, that the collateral provider be entitled to substitute or exchange one type of financial collateral for an equivalent amount of another type of financial collateral. Often, but not necessarily always, the collateral taker's consent to such a substitution is required. Currently, there is some uncertainty as to whether or not the collateral provider's right to substitute collateral would cause what is otherwise intended to be a fixed charge to be characterised by an English court as a floating charge. Even the requirement that the collateral taker consent to such a substitution does not entirely eliminate the current theoretical uncertainty.

While we are not aware of any English case directly on point, this uncertainty is unhelpful to market participants, and is one of the reasons why title transfer financial collateral arrangements are so commonly used. This issue concerns not only the question of whether the arrangement would fall within the registration of charges regime (which is otherwise dealt with by the regulations), but also concerns

² For example, because of differences in the formulation of the rule in Article 9(2) of the Directive (98/26/EC) on settlement finality in payment and securities settlement systems, Article 9 of the Directive, Chapter II of the Hague Convention, and at national level in the implementation of these rules.

the relative ranking of the collateral taker's rights against financial collateral and the increased vulnerability of floating charges to avoidance (as addressed elsewhere in the consultation document).

We therefore urge you to include in the draft regulations a provision to the effect that the inclusion of a collateral provider's right to substitute collateral would not, of itself, cause what would otherwise be a fixed charge to be characterised as a floating charge.

(5) *Credit ratings related provisions in financial collateral arrangements*

It is very common in financial collateral arrangements for certain of the mechanical provisions relating to the calculation of collateral to be delivered under the mark-to-market provisions of the arrangement to be linked to the rating allocated by one or more of the recognised rating agencies to, for example, the senior unsecured long-term debt of a counterparty. This helps to ensure, among other things, that parties are not required to provide more collateral than is actually necessitated by their general creditworthiness at the relevant time.

As such provisions would, of course, generally result in a party being required to provide more collateral when its financial condition has declined, it has sometimes been suggested that such provisions might be vulnerable to avoidance under preference or similar rules in some countries. We understand that under current English insolvency law purely mechanical provisions of this type are unlikely to be objectionable, if entered into in good faith at arm's length while both parties are solvent and prior to the commencement of any relevant insolvency suspect period.

Nonetheless, because of the theoretical doubts mentioned above, we recommend that the regulations include a provision clarifying that the inclusion of such provisions would not of itself (subject to appropriate conditions along the lines above) render a financial collateral arrangement vulnerable to avoidance under any current UK insolvency rule relating to preferences, transactions at an undervalue, or transactions defrauding creditors.

We thank you once again for the opportunity to comment on the consultation document. If you would like to discuss any of the issues in this letter, please do not hesitate to contact Edward Murray of Allen & Overy (ed.murray@allenoverly.com), who is the Chairman of our Collateral Law Reform Group, or the undersigned.

We are fully supportive of the principles and purposes of the Directive and the draft regulations. We applaud HM Treasury's thorough review of the relevant issues, the careful thought reflected in both the consultation documentation, and the draft regulations, and the openness of the current consultation process to input from financial market practitioners. We stand ready to provide any further information or assistance, for example, regarding international financial market practice, that may aid in the process of implementation in the United Kingdom of this crucial European internal market measure.

Yours faithfully,

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ANNEX

The International Swaps and Derivatives Association

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 interest rate, currency, commodity, credit, and equity swaps, options, and forwards, as well as related products such as caps, collars, floors, and swaptions.

ISDA was chartered in 1985 and today numbers over 600 member institutions from 46 countries on six continents. These members include most of the world's major institutions who deal in, and leading end-users of, privately negotiated derivatives as well as associated service providers and consultants. A list of ISDA's members is available from the website at <http://www.isda.org>.

Nearly half of ISDA's members are European institutions, with the next largest group being North American, followed by members from the Asia-Pacific region and South America. The majority have significant operations in the City of London and/or regular dealings with other market participants operating from the City of London. Of the 20 primary members represented on ISDA's current Board of Directors, 11 are European institutions, all with significant operations in the City of London. ISDA's current Board of Directors includes senior bankers from Barclays Capital, the Royal Bank of Scotland, and Standard Chartered Bank.

ISDA's members therefore have a deep and longstanding interest in the legal and regulatory framework for financial transactions in Europe and specifically in the United Kingdom, particularly given the importance of the City of London as an international financial centre and the fact that a large proportion of cross-border derivatives documentation is governed by English law.³

³ For further information on ISDA generally, please consult our website at <http://www.isda.org>.