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BY E-MAIL AND BY POST

The Law Commission
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For the attention of: James Robinson

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Dear Sirs

Consultative Report (Consultation Paper No 176): Company Security Interests

We thank you for your kind invitation to comment on your consultative report on *Company Security Interests*. We recognise that your proposals represent a far-reaching reform of the law of England and Wales relating to personal property security interests created by corporate entities. We are grateful for this opportunity to comment on the consultative report, which represents an impressive achievement in its thoroughness and detail.

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. 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.

We have a particular interest in these proposals as a significant proportion of financial collateral arrangements entered into on standard form documentation that we have published are governed by English law.[1] 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.

ISDA has participated in a number of consultations in the United Kingdom, including recent consultations by HM Treasury, the Financial Services Authority, the Bank of England and the Financial Markets Law Committee on legal and regulatory matters affecting the European financial markets, and we are grateful for each opportunity to express industry concerns about legislative initiatives affecting our markets, to provide information about market practice where helpful in shaping legislative policy and generally to encourage appropriate and market-sensitive modernisation of legal regimes in this area.

In commenting on the consultative document, we are conscious that the proposed reforms go well beyond our area of principal concern and expertise, namely, the professional or "wholesale" OTC derivatives markets. Accordingly, we focus our comments primarily on the provisions dealing with financial collateral, although we also comment below on issues of potential relevance to close-out netting and contractual set-off, both of which are extremely important contractual techniques for the reduction of credit and settlement risk in our markets. At the same time, we recognise that the parts of the proposed reforms with which we are principally concerned must be seen in context, as part of a larger whole.

In responding to the consultative report, we defer to national legal experts in the United Kingdom as to the technical detail of the proposed regime and its interrelationship with, and impact upon, existing law. In this regard, a number of our legally qualified members have been involved in other more detailed responses to the consultative report. We have also had the advantage of having reviewed in final draft form the response of the Financial Law Committee of the City of London Law Society (the ***CLLS***) to the consultative report.

Our principal conclusion is that, while the consultative report includes proposals that would potentially be of some benefit to the financial markets, there is a great deal in the consultative report that gives cause for considerable concern. In this regard, we are in substantial agreement with the conclusions and supporting analysis of the Financial Law Committee of the CLLS.

Is there a need for radical reform in relation to financial collateral arrangements?

1. As far as financial collateral arrangements are concerned, there is no need for radical change. Far from it. At most, some incremental "tidying up" would be desirable. Existing law, particularly following the implementation of the European Directive on

[1] See the ISDA Margin Survey 2004, available from the ISDA website (http://www.isda.org) for some empirical data on financial collateral arrangements entered into under the 1995 ISDA Credit Support Annex governed by English law (the ***English Annex***) and the 1995 ISDA Credit Support Deed governed by English law (the ***English Deed***). The English Annex, which creates a title transfer financial collateral arrangement under English law, is the second most widely used form in the cross-border market for privately negotiated derivatives after the 1994 ISDA Credit Support Annex governed by New York law. The English Deed, which creates a security interest under English law, has traditionally not been favoured because of various difficulties and inconveniences arising under English law prior to the implementation in the United Kingdom of the EU Directive on financial collateral arrangements.

financial collateral arrangements[2] (the ***FCA Directive***) in the United Kingdom by the Financial Collateral Arrangements (No. 2) Regulations 2003 (the ***FCA Regulations***), provides a relatively strong, clear and straightforward legal framework for financial collateral arrangements. We believe that the law would benefit from reform of the law relating to floating charges, although most security (as opposed to title transfer) financial collateral arrangements are, in any event, structured as fixed charges. We believe that clarifications of certain provisions of the FCA Regulations would be welcome. For example, it would be helpful to have some clarification of what constitutes "control" for purposes of the requirement that financial collateral be "delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral-taker or a person acting on its behalf". Some clarification of the definition of "financial collateral" would also be desirable. Apart from some minor additional clarifications of the FCA Regulations, none of which are absolutely necessary (as we believe that the FCA Regulations should, in any event, be construed purposively and not given a narrow, technical reading), we believe that current English law leaves little to be desired as the governing law of a financial collateral arrangement.

2. We note that the consultative report proposes clarification of the concept of "control", and we have already indicated that this would be welcome. Nonetheless, we are concerned at the complexity of the specific proposals in this regard, although we are conscious that these proposals are attempting to get to grips with a much broader class of collateral assets than just financial collateral and a wide variety of related commercial and financial transactions.

Recharacterisation risk

3. The predominant governing law for cross-border derivatives transactions in the European market is English law, even where neither party is English and neither party is operating from an office in England.[3] English law is also widely used in other parts of the world, in particular, in Asia. There are no doubt a number of reasons for this, historical and otherwise, but among those reasons are the strong perceptions that English law is predictable and that English courts respect freedom of contract. Financial market participants expect that English courts will enforce English law governed financial contracts between professional parties, as far as possible, as written.

4. It follows from the foregoing that we strongly oppose the inclusion of title transfer collateral arrangements within the scope of the proposed regime to the extent that title transfer financial collateral arrangements would be considered a form of "quasi-security". The introduction of recharacterisation risk in relation to such arrangements would be damaging to legal certainty and the principle of freedom of contract. These, and the relative predictability of English law, are key to its flexibility, giving confidence to the dynamic and innovative forces in the financial markets that innovative contractual arrangements can be structured with a minimum of legal and documentation risk. The

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

[3] During the preparation of this response, a senior member of the Legal Department of one of our primary members, one of the largest banks in Europe and represented on our Board of Directors, informed us that more than 80% of their cross-border derivatives documentation is governed by English law, even though it is headquartered in a eurozone member state.

introduction of recharacterisation risk would therefore, in our view, be damaging to the prestige that English law currently enjoys in the international financial markets.

5. Prior to the introduction of the FCA Directive, one of the principal advantages of English law as the governing law of cross-border title transfer collateral arrangements relative to the laws of a number of other European member states was the fact that the risk of recharacterisation of a title transfer collateral arrangement as a form of security arrangement was virtually non-existent.

6. While ISDA's own empirical research shows that the majority of derivatives collateral arrangements are documented under the ISDA Credit Support Annex governed by New York law,[4] this is explicable by reference to the fact that US Dollar Cash and US Treasuries are by far the most popular and widely used collateral assets. While the regime for the creation of security interests in investment property under Article 9 of the New York Uniform Commercial Code (the ***NYUCC***) is widely perceived to be robust, flexible and efficient, the risk of recharacterisation of other types of non-security contractual arrangements as a form of security interest has long been considered in the financial markets to be one of the less satisfactory aspects of Article 9. In relation to the North American securities repurchase (***repo***) market, the uncertainty created by the recharacterisation risk under Article 9 has been more a disadvantage to be overcome by the market than a favourable factor. Apart from the repo market, title transfer collateral arrangements are virtually not used at all in North America. Recharacterisation risk under Article 9 of the NYUCC has been a strong factor in favour of English law in preference to New York law.

A statutory statement of rights and remedies

7. We are concerned about the whole of Part 5 of the consultative report, in particular, if it is proposed to apply to title transfer financial collateral arrangements. Our concerns are, of course, related to our concerns regarding recharacterisation risk. Financial market participants want to be free to structure their arrangements as they see fit. And they want to have confidence that the courts will enforce their bargains, within reasonable limits, as written. For this reason, where they have chosen to structure a financial collateral arrangement as an outright transfer of ownership, they want to know that they can rely on all of the consequences that would be expected to flow from that, including the complete freedom of the collateral-taker to deal with the financial assets originally transferred without let or hindrance by the law. In our view, the whole of Part 5 of the consultative report is inconsistent with this strong desire of financial market participants. There is certainly no demand for anything of this sort in relation to title transfer financial collateral arrangements, nor, as far as we can see, is there any need.

8. We are also sympathetic to the concerns that we know have been raised by others that even in relation to security financial collateral arrangements, Part 5 of the consultative report appears to be overly prescriptive and likely to lead to uncertainty, unpredictability

[4] ISDA Margin Survey 2004, available for free from the ISDA website at http://www.isda.org.

and loss of flexibility. It is also not clear that such a statement of rights and remedies is needed even in relation to security financial collateral arrangements.

Protecting contractual set-off and close-out netting

9. We understand that the provisions in the proposed scheme overriding contractual prohibitions on assignment are meant to apply only to "account debtors" in relation to "accounts", and that "account" is defined to exclude "a monetary obligation evidenced by an instrument", "investment property", "bank accounts" and "a right to payment for money or funds advanced or sold, other than a right arising out of the use of a credit or charge card or information contained on or for use with the card". We appreciate, therefore, that the scheme attempts to exclude "financial collateral". It would be a disaster if the proposed regime raised the slightest doubt about the effectiveness of contractual set-off or close-out netting in relation to financial collateral, particularly under title transfer financial collateral arrangements, which are normally based on one or the other of these contractual mechanisms.[5]

10. Our principal concerns in relation to the proposed override of contractual prohibitions on assignment are as follows:

    (1) "Investment property" and "bank account" are not defined consistently with the definition of "financial collateral" in the FCA Regulations. In particular, "bank account" is much narrower than the definition of "cash" in the FCA Regulations. There must be no doubt that the proposed override of contractual prohibitions on assignment does not extend to financial collateral arrangements within the FCA Regulations. Cash collateral comes in various forms. Under the ISDA standard form Credit Support Documents, cash collateral is normally created by a payment by the collateral-provider to the collateral-taker, which gives rise to a conditional obligation of the collateral-taker to make a future payment in the same currency and amount at a future date. This conditional obligation may, according to the intentions of the parties, be charged back to the collateral-taker, subject to a contractual set-off or included within the close-out netting effected under Section 6(e) of the ISDA Master Agreement. This conditional obligation is not necessarily a "deposit" as that term is used in the definition of "bank account", not least because the collateral-taker under an ISDA Credit Support Document is not necessarily a bank.

    (2) More generally, and potentially even more dangerously, the proposed override should clearly exclude any payment or delivery obligations arising under a financial transaction whether documented under a market standard master agreement such as the ISDA Master Agreement or on a stand-alone basis. In particular, in relation to master agreements, it has been a feature of the over-the-counter derivatives market since its inception in its modern form in the

[5] It is not necessary here to consider in detail the nature of "close-out netting", other than to say that while some market master agreements intended to effect "close-out netting", for example, in the repo markets, are based on contractual set-off, other close-out netting arrangements, for example under an ISDA Master Agreement, are more properly analysed as effecting a "flawed asset" or conditional novation rather than a contractual set-off in the strict sense.

late 1970's, and in particular since market standard documentation began developing in the mid-1980's, that neither party is permitted to transfer any right or obligation without the consent of the other party. This serves a number of purposes, including addressing "know your counterparty" concerns. But one of the most important purposes is to preserve mutuality of obligation between the parties to ensure the effectiveness of the close-out netting effected by the master agreement between the parties.[6] We are not at all comfortable that the current definition of "account" clearly excludes any payment or delivery obligation that might arise under a derivatives master agreement, whether or not supported by a financial collateral arrangement. It is crucial that this be put beyond doubt.[7]

Ensuring compatibility with UK, European and international measures

11. We note that the consultative report refers to other UK, European and international legislative acts and law reform initiatives, including the Settlement Finality Directive,[8] the FCA Directive, the Hague Securities Convention,[9] the proposed European securities account "legal certainty" project,[10] and the UNIDROIT Study Group on Harmonised Substantive Rules Regarding Indirectly Held Securities. We also note the excellent work done on issues relevant to your financial collateral proposals by the Financial Markets Law Committee (the ***FMLC***). We understand that you have reviewed the recent FMLC report on property interests in investment securities in connection with the preparation of your proposals.

12. It is important that any legislation in this area should take proper account of these other developments and initiatives. Other respondents, we believe, have or will be commenting to you on this point in more detail, but we simply note that it does not appear to us that the scheme outlined in the consultative report is fully consistent in spirit or likely effect with the liberalising (and to a greater or lesser extent simplifying) tendency of these other measures and proposed measures.

We conclude by suggesting that it should not be underestimated how much is currently "right" about the existing English law framework for financial collateral arrangements, particularly following the implementation of the FCA Directive. English law is widely used for cross-border financial transactions, including OTC derivatives transactions, and the financial collateral arrangements that support them. This is a ringing endorsement by the market of its current virtues. Incremental improvements will, of course, always be welcome, and we have already mentioned, in particular, that we would welcome a clarification of the concept of "control" as used in the FCA Regulations and a reform of the law relating to floating charges. The introduction of recharacterisation risk in relation to title transfer collateral arrangements and the application of a statutory scheme of rights and remedies seem to us to be wholly negative developments that would not be welcomed by the international financial markets, for whom the

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6 We assume that we do not have to rehearse here the importance of close-out netting in the financial markets both to general credit risk management and to the determination of regulatory capital for supervised financial institutions.

7 This issue was addressed in the UN Convention on the Assignment of Receivables in International Trade.

8 Directive 98/26/EC of the European Parliament and Council on settlement finality in payment and securities settlement systems.

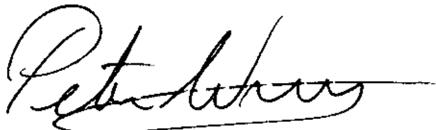
9 Convention on the law applicable to certain rights in respect of securities held with an intermediary of the Hague Conference on Private International Law; not yet in effect.

10 Described in the European Commission Communication "Clearing and Settlement in the European Union – the way forward" published in April 2004.

City of London is such an important centre and English law is a popular and widely used choice of law.

We commend you on the thoroughness of the work reflected in the consultative report and the openness of the consultative process, although we believe that the time for consultation has not been sufficient given the scope of the proposals. If we can be of assistance in relation to your further deliberations on these issues, we would be delighted to help, for example with information on the international financial markets and market practice. We would be pleased to discuss any of the issues raised above, or indeed any related issue, with you in more detail. If you would find that helpful, please do not hesitate to contact either of the undersigned.

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, including related financial collateral agreements, is governed by English law.[11]

[11] For further information on ISDA generally, please consult our website at http://www.isda.org.