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BY E-MAIL

United Nations Commission on International Trade Law  
International Trade Law Division (UNCITRAL Secretariat)  
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For the attention of: Spiros V. Bazinas, Senior Legal Officer

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Dear Sirs

### **UNCITRAL Working Group VI – Draft Legislative Guide on Secured Transactions**

Thank you for your kind invitation to comment on the discussion draft prepared by the UNCITRAL Secretariat entitled “Recommendations of the UNCITRAL draft Legislative Guide on Secured Transactions” dated 16 March 2007 (Reference A/CN.9/631). In this letter below, we use the term “**Discussion Draft**” when referring to the current discussion draft and “**Legislative Guide**” when referring to proposed document in final form.

The International Swaps and Derivatives Association, Inc. (**ISDA**) is the global trade association representing leading participants in the privately negotiated derivatives industry (more than 780 institutions from over 50 countries), 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. Promoting legal certainty for cross-border financial transactions through law reform has been one of ISDA’s core missions since it was chartered in 1985.

Over the years ISDA has followed the work of UNCITRAL in promoting law reform in international trade law and applauds its efforts to strengthen legal certainty and promote harmonization of national private law rules affecting commercial and financial transactions. ISDA has, of course, taken a particular interest in those UNCITRAL projects touching on financial markets matters and has participated at your kind invitation as an Observer at some of the meetings of Working Group VI.

We do not propose in this letter to provide a comprehensive commentary on the Discussion Draft but only to comment on two aspects of the Discussion Draft of particular relevance to the financial markets:

1. Securities. We note that the Discussion Draft includes (tentatively, as indicated by brackets and the accompanying Note to the Commission) securities other than (i) intermediated securities as defined in the draft UNIDROIT Securities Convention<sup>1</sup> and (ii) securities traded on a regulated exchange. You asked for our views as to the potential for overlap or conflict with the work of UNIDROIT, EU Directives or market practice in the securities markets.

To the extent that the proposed scope is limited to non-intermediated and non-traded securities, the principles set out in the Discussion Draft would very rarely, if ever, be relevant to collateralized derivatives transactions. It would probably not be appropriate for us to comment in detail at this stage on the Discussion Draft (for example, in terms of consistency with the rest of the Legislative Guide), especially given the many experts who are already members of the Working Group and will be considering that detail, but we do have some general observations, which we hope you will find helpful.

Our general comments are as follows:

- (a) In terms of scope, we note that a potentially important class of securities, namely, non-intermediated traded securities, are excluded. A collateralized derivatives transaction, if it involves non-intermediated securities at all, is more likely to involve traded securities than non-traded securities. We assume that traded securities have been excluded in order to avoid any potential impact on the capital markets of these proposed rules, as suggested in the Discussion Draft. But we wonder, in that case, why the Working Group are particularly interested in covering some, but not all, non-intermediated securities.
- (b) We understand that you are concerned about potential overlap with UNIDROIT. But if that is the case, then it might make sense *a priori* to avoid any possible overlap by having the UNIDROIT project to cover all types of securities, both intermediated and non-intermediated, rather than have three separate possible regimes for securities, (namely, UNIDROIT for intermediated securities, national rules based on the UNCITRAL Legislative Guide for non-intermediated

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<sup>1</sup> The current version being the UNIDROIT Preliminary Draft Convention on Substantive Rules Regarding Intermediated Securities (Study LXXVIII – Doc. 57) (November 2006).

non-traded securities and non-harmonized national rules for non-intermediated traded securities). We understand, of course, that the scope of the UNIDROIT project is a matter for UNIDROIT rather than yourselves, but we would be interested in hearing in more detail why the members of the Working Group feel it is necessary to cover non-intermediated non-traded securities.

- (c) We understand that it has been suggested that the appropriate rules for governing security interests in non-intermediated non-traded securities could closely parallel the rules with respect to negotiable instruments. This may be the case, but we would suggest that particular care should be taken to distinguish between (i) bearer certificated securities, (ii) registered certificated securities where the certificate is a primary evidence of title and (iii) registered certificated securities where the register is the primary evidence of title. In this third case, in particular, the rules relating to negotiable instruments may not be appropriate, and it may be that even in relation to the second case substantial adjustments would be advisable.
  - (d) In terms of compatibility of the proposed rules in the Discussion Draft with EU Directives, we have not studied this in detail, of course, but as you know we were heavily involved in the consultative process that led to the adoption of the European Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements (**FCAD**). Among the key priorities for ISDA were the recognition of title transfer collateral arrangements, the elimination of recharacterisation risk in relation to title transfer collateral arrangements, the elimination of formalities in relation to the form and content of agreements for financial collateral arrangements, and the elimination of formalities for perfection (such as registration). The Discussion Draft appears to be inconsistent with FCAD on those points, although we appreciate that by limiting the scope of the Discussion Draft to non-intermediated non-traded securities nothing that falls within the definition of “financial collateral” in FCAD is caught by the Discussion Draft. Obviously if the scope were to be widened to include non-intermediated traded securities, then there would appear to be a number of apparent inconsistencies with FCAD that would require some attention to reconcile, particularly as to formalities and recharacterisation risk.
2. Financial contracts. We are continuing to review the Discussion Draft as it relates to financial contracts. We note that definitions of “financial contract”, “netting” and “netting agreement” have been added to the Discussion Draft and that the first of these is essentially the same as the corresponding definition in the United Nations Convention on the Assignment of Receivables in International Trade (the **Receivables Convention**). We note, however, that the definition is arguably no longer broad enough to reflect the full range of financial contracts actively traded in the international financial markets. You should consider expanding it to cover transactions relating to inflation and other economic statistics, emissions allowances, freight rates, weather, bandwidth and other quantitative measures associated with an occurrence, extent of an occurrence, or

contingency associated with a financial, commercial or economic consequence or measure of economic or financial risk or value.

In relation to the definition of “netting” we note that set-off is only one legal technique used to effect the netting of financial obligations and, for example, is not the primary legal technique used by the various Master Agreements published by ISDA, which are based on a “flawed asset” approach rather than on set-off. Also, strictly speaking set-off in relation to non-monetary obligations is not possible, except, arguably, in relation to strictly fungible assets. Typically a netting arrangement would provide for non-monetary obligations to become monetary obligations (by an appropriate process of valuation at or about the time of a default, for example), which might then be included in the set-off (or other form of netting, such as the flawed asset approach).

We note that sub-clause (ii) of your definition of “netting agreement” appears broad enough to encapsulate the flawed asset approach, and we note that this appears to track the corresponding definition in the Receivables Convention. We suggest that the drafting of this definition could be improved in light of the development of the markets and related jurisprudence since the Receivables Convention was published.

We suggest that financial contracts should be excluded from the scope of the Legislative Guide or, if not excluded, then further consideration should be given to:

- (a) whether the conflict of laws rule in Recommendation 204 (law applicable to a security right in intangible property) is appropriate for security in financial contract collateral (we are aware that there is a strong school of thought that it is not the appropriate rule, although this is not a matter on which ISDA has formulated an official position as a trade association; we note that there is on-going work in Europe of relevance to this point in the context of the so-called “Rome I Regulation” which is intended to replace the Rome Convention of 1980 on the law applicable to contractual obligations);
- (b) ensuring that control is the principal or exclusive means of perfecting a security interest in a financial contract (registration is unnecessary from a policy point of view and economically burdensome in the context of fast-moving financial transactions; if it remains an alternative in the Legislative Guide, it should be voluntary rather than mandatory and confer a lower priority than the priority conferred by control); and
- (c) the prohibition on anti-assignment clauses in Recommendation 25 (effectiveness of an assignment of receivables made despite an anti-assignment clause) should clearly exclude the assignment of a financial contract (broadly defined as we suggest; the current oblique reference in sub-paragraph (c) of that Recommendation to a “contract for the supply ... [of] financial services” is not sufficient broad or clear to provide the necessary certainty and protection from this rule.

Our point in (c) above is particularly important in the context of ensuring the integrity of netting agreements, and the certainty and stability of counterparty relationships in the financial markets, as acknowledged by UNCITRAL at the time of preparation of the Assignments Convention.

We understand that the Commission will be meeting in Vienna in June of this year and that review and possibly approval of the Legislative Guide will be on the agenda. We understand that it is not normally the purpose of a Commission session to draft or otherwise work on the detail of an UNCITRAL document, so we are not certain how the outstanding issues relating to non-intermediated non-traded securities and financial contracts will be resolved.

We understand also that a further session of Working Group VI is currently scheduled for September of this year. It is not clear to us procedurally what the significance of Commission approval of the Legislative Guide in June would be if further work continues on the Legislative Guide after such approval is given. These are matters, of course, for the Commission and the Member States, but in terms of financial market understanding and acceptance of the Legislative Guide in its final form, it would be helpful if further guidance could be given on these points.

As the points relating to the scope of the Legislative Guide in relation to securities and in relation to financial contracts are of importance to the financial markets, we hope and trust that sufficient time will be given by UNCITRAL to consideration of them in June or, if necessary, in subsequent meetings of Working Group VI.

We hope that this is helpful and would be pleased to discuss these issues with you further. Should you wish to do so, please do not hesitate to contact the undersigned (by e-mail at the address below or by telephone in London at +44 20 3088 3550).

Yours faithfully,

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