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BY POST AND E-MAIL

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International Institute for the Unification of Private Law (UNIDROIT)
Via Panisperna, 28
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For the attention of Dr Philipp Paech

E-mail: ph.paech@unidroit.org

Dear Sirs,

Preliminary Draft Convention on Harmonised Substantive Rules Regarding Securities Held with an Intermediary (Study LXXVIII – Doc. 18)

Thank you for your letter of 31 January 2005 informing us of the first session of the UNIDROIT Committee of governmental experts for the preparation of the preliminary draft Convention referred to above (the **Draft Convention**) from 9 to 20 May 2005 and inviting us to designate one or more observers to represent the International Swaps and Derivatives Association, Inc. (ISDA). We are pleased to accept your kind invitation and will be in contact separately with regard to the names of our observers and other administrative arrangements in connection with the May session.

As you know, we have been following this initiative with great interest, having commented in our letter of 6 September 2002 on the proposed scope of the project, in our letter of 11 November 2003 on your Position Paper of August 2003 on Harmonised Substantive Rules Regarding Indirectly Held Securities and in our letter of 3 September 2004 on the preliminary draft Convention published by UNIDROIT in April 2004.

ISDA is the global trade association representing 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. Promoting legal certainty for cross-border financial transactions through law reform is one of ISDA's core missions. ISDA was chartered in 1985 and today numbers over 600 member institutions from 47 countries on six continents.¹

ISDA continues strongly to endorse this initiative. This is important work. We believe that the reasons why this is so are well set out in Part 2 of the Explanatory Notes (Study LXXVIII – Doc.19) (the **Explanatory Notes**).

Clearly, law reform on this scale takes time and requires careful consideration. We note that the UNIDROIT Governing Council decided to commence work on this project in September 2001. Given the size and importance of the international securities markets, it is important that this project now moves forward as quickly as possible to the conclusion of an international instrument on these issues.

We not only endorse this initiative, but we also endorse the functional approach described in Part 3 of the Explanatory Notes, the use of neutral language and the importance of ensuring that the instrument is acceptable to, and can be effectively implemented in, jurisdictions of all of the world's major legal traditions. The Explanatory Notes caution that there are limits to the functional approach, and we agree that a careful balance needs to be struck to ensure that the goals of legal certainty and international compatibility are achieved.

In this regard, there are references in some articles of the Draft Convention to the relevant applicable law (as defined in Article 1(3)). We believe that the intended interaction between the rules in the Draft Convention and the applicable law is not always as clear as it could be, and we would urge that these references should be given careful attention at the governmental experts session in May of this year.

We are pleased to note that points we raised concerning the prior preliminary draft Convention are now included or reflected more clearly in the Draft Convention. The Explanatory Notes on the detail of each Article of the Draft Convention are particularly helpful. We do have some continuing concerns, which are noted below.

We continue to underline strongly the importance, in particular, of ensuring that the particular characteristics of securities intermediation do not frustrate the reasonable expectations of market participants, for example, in relation to issues such as an account holder's right to receive interest or dividends or other distributions, to exercise voting or other corporate rights or to exercise a right of set-off against an issuer of securities to the extent that it would have had such a right under the direct holding system. We note that these issues are dealt with in Articles 2(1), (3) and 18. Article 18 is of particular importance from the point of view of the financial markets.

A consistent theme in our prior comment letters to UNIDROIT regarding this project has been the importance of recognising and giving proper effect to title transfer collateral arrangements. In

¹ For further information on ISDA and its activities, please consult our website at <http://www.isda.org>.

the privately negotiated derivatives market, a significant proportion of financial collateral arrangements are based on the title transfer approach, rather than on the creation of a security interest in financial collateral. In some parts of the world, for example, in Europe, it is the predominant approach used for cross-border collateralised derivatives trading.²

We note that the Draft Convention recognises the existence of title transfer collateral arrangements, for example, in the definition of “disposition” in Article 1(h),³ and any of the provisions relating to transfers of securities will therefore clearly be relevant to such arrangements. Article 3 is especially helpful in this regard, in particular, of course, Article 3(6).

We believe, however, that Chapter VII, which includes the special provisions with respect to collateral transactions, should be expanded to cover title transfer collateral arrangements. Articles 20 and 21 would continue to be relevant only to security interest collateral arrangements, but Article 22 should apply to both security interest and title transfer collateral arrangements. Also, an additional Article should be added to this Chapter to deal specifically with the issue of recharacterisation risk in relation to title transfer collateral arrangements and to strengthen local law relating to netting and/or insolvency set-off as necessary to ensure the effectiveness of title transfer collateral arrangements.

We note that this “twin track” approach of protecting both security interest and title transfer collateral arrangements is reflected in both the European Financial Collateral Directive⁴ and also the Hague Securities Convention⁵.

We think that it is regrettable that it is necessary to include an opt-out from Chapter VII, but we understand the reasons for this, as set out in the Explanatory Notes.

As we have previously noted in our letter of 3 September 2004, we would favour extending the scope of the Draft Convention to include natural persons. We note the discussion of this point in the Explanatory Notes, and in particular the suggestion, with which we agree, that it is not clear that a natural person as collateral provider would be less protected under this regime. In fact, a natural person would benefit, as would any market participant, from the greater certainty and other benefits of the proposed regime.

² For statistical information on the various types of financial collateral arrangement used in the cross-border privately negotiated derivatives market, see ISDA’s annual Margin Surveys. These may be consulted on the ISDA website at <http://www.isda.org>.

³ For this reason, we would favour retaining this definition (that is, removing the square brackets) and adding a definition of “acquisition”, as suggested in the Explanatory Notes.

⁴ Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

⁵ The Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary, the text of which was adopted by the Hague Conference on Private International Law in December 2002 (but which is not yet in force).

We are not proposing to offer a comprehensive commentary on drafting issues in this letter, but we thought it might be helpful to offer the following few points:

1. It would be helpful to clarify the position of, say, a trustee or a comparable fiduciary as account holder in relation to Article 2(1). Sub-paragraph (a) deals with the position of the “ultimate” holder, but the Article appears to be silent on the rights of a trustee or a comparable fiduciary to receive the benefits of or exercise the rights associated with the securities for its beneficiaries.
2. It might be helpful in a future draft of the Explanatory Notes to explain more clearly how the perfection of security interests is dealt with in the Draft Convention, which appears to be a combination of provisions in Articles 3 and 4 and possibly elsewhere. The necessary elements appear to be there, but it would be helpful to have a description of how it all “hangs together”, especially given the importance of the concept of “control” of book-entry securities to the issue of perfection in, for example, the European Financial Collateral Directive and in Articles 8 and 9 of the US Uniform Commercial Code (and in similar personal property security statutes of other jurisdictions such as New Zealand and the Canadian provinces).
3. In Article 18(1), perhaps it should be clarified that this provision only applies where the account holder is “acting for its own account with respect to the securities” (which tracks language used in Article 2(1)(a)).
4. In Article 20(2) is it necessary to qualify the secured obligations as being obligations “of a financial character”? Presumably any debt, whether arising out of a financial transaction, a commercial transaction or otherwise, should be eligible to be collateralised by an arrangement benefiting from these provisions.
5. As a general principle, we would like to see definitions in the Draft Convention that also appear in the Hague Securities Convention conformed as far as possible. The Hague Securities Convention deals with a fundamental threshold issue, namely, which law is applicable, and may be viewed as a foundation stone of the legal certainty project for intermediated securities. To that extent, the Draft Convention should build on the work reflected in the Hague Securities Convention and any legal certainty issues arising from inconsistencies between the two documents should be eliminated as far as possible.

We wish to commend the Study Group for the hard work it has done, for the high quality of the Draft Convention and the Explanatory Notes. We would be pleased to continue to support this project in any way that we reasonably can, for example, by providing further information or assistance regarding international financial market practice. ISDA and its members will continue to follow the development of this project with great interest. If you have any questions regarding our comments or desire any further information, please feel free to contact the undersigned.

Yours faithfully,

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