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BY POST AND BY E-MAIL

3 September 2004

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

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Dear Sirs,

Draft convention on substantive rules regarding securities held with an intermediary

We are grateful for the opportunity to comment on the preliminary discussion draft convention on substantive rules regarding securities held with an intermediary, published by UNIDROIT in April 2004. As you know, the International Swaps and Derivatives Association, Inc. (*ISDA*) has taken a close interest in this project since its inception, having commented on the proposed scope of work in our letter of 6 September 2002 and on the position paper prepared by the UNIDROIT Study Group for this project in our letter of 11 November 2003.

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. ISDA was chartered in 1985 and today numbers over 600 member institutions from 46 countries on six continents.¹

We note that the draft Convention is marked as a "preliminary discussion draft", with the implication that the text is tentative and significant further work is required. We do not propose at this stage, therefore, to offer detailed drafting comments, which we would be pleased to do when the draft is more developed or at any other time at your request.

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

For present purposes, our first, and perhaps most important, point is that this project needs detailed financial industry input. In our letter of 11 November 2003, we noted that the Hague Securities Convention² benefited immeasurably from the regular consultations that were conducted by the Permanent Secretariat of the Hague Conference on Private International Law with a stable group of experienced industry practitioners. This is key to ensuring the future effectiveness, market compatibility and broad acceptance of an eventual Convention on these issues. We note that the Secretariat of UNIDROIT has on more than one occasion acknowledged the importance of this and made it clear that detailed industry input will be organised once the project has reached a certain stage of development, possibly by the Spring of 2005. We understand that the Study Group will be meeting in Budapest later this month. We would be pleased to offer advice and assistance as to how best to ensure effective industry input at the appropriate time.

We are pleased to see that certain issues of importance to the financial markets, and in particular the derivatives markets, and which we highlighted in our earlier letters, have been addressed in the draft convention. For example, in our letter of 6 September 2002 we emphasised the importance of addressing the question of set-off of a holding of securities with an intermediary against claims owed to the issuer of those securities. We are pleased to see this reflected in Article 20 of the draft convention.

While specific reference to enforcement of collateral arrangements was omitted from the original draft scope of work and this absence was commented upon in our letter of 6 September 2002, we are pleased to see that article 21 deals with this, including in article 21(3)(b) mandating a secured party's right to realise its security by appropriation of the relevant collateral and in article 21(4)(b) protecting collateral arrangements from the effect of insolvency proceedings, including by implication from the effect of insolvency stays or freezes.

We are also pleased to see that article 8 addresses the protection of rights of account holders on the insolvency of intermediary, which we believe should remain one of the core principles of any future convention regime. We mention this because we understand that at one stage of this project it was not clear that the Study Group intended to propose this as a core principle but was considering instead including it in less formal guidance or model principles.

We believe, however, that there are at least three important respects in which the draft convention can be, and should be, strengthened if it is to confer an important benefit on the security and integrity of the financial trading markets:

1. Article 21 of the draft convention should clearly cover title transfer collateral arrangements, including the title transfer collateral arrangements that form a key component of securities repurchase (repo) and securities lending transactions. ISDA's own empirical work on collateral management shows that most collateral arrangements established in the European over-the-counter derivatives markets, whether or not done under ISDA documentation, are based on transfer of title rather than on creation of a security interest.³

Both the European Financial Collateral Directive⁴ and the Hague Securities Convention acknowledge and cover both forms of collateral arrangement. Article 21, however, clearly only covers security ("creates a security interest"). A transfer of title, even for a security purpose, does

² The Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary, concluded at the Hague in December 2002 (not yet in force).

³ ISDA has conducted an annual survey of collateral management practices over the past few years. The latest Margin Survey ("margin" being a synonym for "collateral" in this context) is available from the ISDA website referred to in footnote 1.

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

not involve the creation of a security interest in the common law jurisdictions of the United Kingdom and Ireland. We appreciate that the distinction is perhaps less clearcut in civil law jurisdictions where, as, for example, in Italy, a transfer of title by way of security might be assimilated to an irregular pledge. Article 21 should therefore be revised to ensure that it covers title transfer arrangements.

This would include extending article 21 to deal with, and eliminate, recharacterisation risk relating to title transfer collateral arrangements in a manner comparable to Articles 6 and 7 of the Financial Collateral Directive.

2. The provisions of the draft convention should expand the protection of collateral arrangements from the effect of insolvency rules such as preference, zero hour and similar rules where those would invalidate collateral transfers, for example, pursuant to mark-to-market or collateral substitution provisions on the sole basis that such transfers occurred during a "suspect period" or after a cut-off time.

Clearly, where an arrangement is as a whole offends a preference or similar rule, it should not be protected. But normal operation of market collateral arrangements should not be invalidated. Again, this is consistent with the approach taken in Article 8 of the Financial Collateral Directive, and is a point we raised in our letter of 11 November 2003.

We also believe that the opportunity should be taken specifically to clarify that normal mark-to-market collateral arrangements involving thresholds, minimum transfer amounts and/or other provisions that are linked or vary according to the credit rating of a party should not be invalidated by preference or similar rules. A significant proportion of master netting agreements and collateral arrangements include such provisions, which provide important credit protection for financial market participants and help to do so on a more cost-effective basis (for both parties) than would be the case if such provisions were not included.

3. Close-out netting, broadly defined to include contractual set-off and novation or "flawed asset" approaches to close-out netting, should be reinforced to the extent that close-out netting forms the basis of a collateral arrangement. This point clearly interrelates with our first and second points above. Again, this is consistent with Article 7 of the Financial Collateral Directive.

In many important ways, the draft convention is broader and more ambitious than the Financial Collateral Directive, dealing not only with collateral arrangements but all dealings in securities through intermediaries. We think that this is good, and necessary. The draft Convention should therefore confer at least the degree of legal certainty conferred by the Financial Collateral Directive in those respects mentioned above.

Although we are not offering detailed drafting comments at this stage, we thought that it might be helpful if we made three drafting comments at this stage:

- (a) We think it would be helpful to include a definition of "person" in the draft convention in order to clarify that references to "person" in the convention include both legal and natural persons. Account holders, for example, who are natural persons should be assured of the same protections under the convention as corporate account holders.
- (b) We believe that the Study Group should consider whether article 19(2) should be subject to article 20 as well as to article 19(1).

- (c) Regarding article 22(5) we note that a collateral agreement may not itself provide for those consequences set out in sub-paragraphs (a) and (b), which may instead be provided for in a master netting agreement to which the collateral agreement is attached, as would typically be the case with an ISDA Master Agreement, which establishes the close-out netting of terminated transactions, and a related Credit Support Annex, which includes the relevant security or title transfer provisions that give effect to the collateral arrangement.

We wish to commend the Study Group for the hard work it has done so far on this important project and reiterate our support. We would be delighted to provide any further information or assistance regarding international financial market practice or otherwise that may be helpful to you. ISDA and its members will continue to follow the development of this project with great interest. Please feel free to contact either of the undersigned if you have any questions or desire any further information.

Yours faithfully,

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