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COMMISSION ACTION PLAN ON EUROPEAN CONTRACT LAW

The International Swaps and Derivatives Association (ISDA) welcomes the opportunity to comment on the Commission's Communication of 12 February 2003 to the European Parliament and the Council "A More Coherent European Contract Law: An Action Plan".

ISDA is the global trade association representing leading participants in the private negotiated derivatives industry, a business that includes interest rate, currency, commodity, credit, and equity swaps, 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.¹

Enhancing legal certainty for cross-border financial transactions is one of ISDA's key missions. A considerable proportion of the resources of ISDA and its members are devoted to acquiring legal opinions from a wide range of jurisdictions on netting and collateral arrangements, and related issues, as well as promoting law reform and participating in consultations on legislative and regulatory developments affecting the financial markets. To the extent that the measures proposed in the Action Plan strengthen legal certainty for cross-border privately negotiated derivatives transactions, then clearly ISDA would support them.

We note, however, that the Action Plan is ambitious and includes various aspects, such as the proposed preparation of an optional instrument, that will potentially involve several years of work and will necessitate considerable work by and co-operation between relevant experts in current and future Member States, as well as broad consultation with all relevant stakeholders in those Member States. The issues involved, as well as the linguistic, social, cultural, economic, and historical barriers that must be overcome, make it very difficult to assess whether all of the proposed actions are feasible or would yield lasting practical benefits, even allowing for a protracted timescale.

We also note that, while the Action Plan contemplates measures that impact on the contractual aspects of all sectors of commercial life, including consumer transactions, ISDA's own mission is limited to the wholesale financial markets, that is, to privately negotiated derivatives transactions between professional financial market participants, including sophisticated corporate and governmental end-users.

Acknowledging that our perspective is limited to these concerns, we offer the following observations:

1. Problems identified in the Action Plan

The Action Plan in our view correctly identifies certain general problems that it would be highly desirable to address, namely:

- (a) the need to improve the coherence and consistency of the EC *acquis* in the area of contract law as well as to improve the drafting of future EC legislation affecting contractual matters;

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

- (b) the need to improve the process of national implementation of EC Directives so that there is much greater consistency in this regard than currently exists;
- (c) the need to promote, as far as possible, uniform principles of interpretation of EC legislation in national courts; and
- (d) in connection with the related consultation on the Rome Convention, which is referred to in the Action Plan, the need to clarify existing conflict of laws rules and to promote convergence of those rules.

2. Other problems

The Action Plan mentions uncertainties relating to the enforceability of reservation of title clauses and divergences between Member State laws in this regard. As this question to some extent implicates property law in many Member States, it raises the broader question of whether it is feasible to focus on contractual law issues in isolation from property law or from other areas of the law of obligations.

If the aim is to improve legal certainty in commercial life, then insolvency law issues may also need to be addressed beyond the limited measures of the Insolvency Regulation and the winding up directives for credit institutions and insurance undertakings.

Some commentators are of the view that certain divergences in Member State laws relating to property and insolvency law matters, including mandatory rules in these areas, raise much greater concerns for cross-border financial transactions than do any current inconsistencies in Member States contract law rules. This appears to be acknowledged in the Action Plan at least in relation to security in goods or other personal property. We have commented extensively in other correspondence with the Commission on the problems raised by inconsistencies in financial regulation between the Member States.

3. The value of harmonisation and the optional instrument

As far as the professional financial markets are concerned, there is no inherent value in the harmonisation of contract law between the Member States for its own sake. Legal certainty is the paramount concern. Provided that the applicable law is clear (which, as far as contractual matters are concerned, would normally be the case as a result of an express choice of law by sophisticated market participants), then the parties can structure their transactions on the basis of that law, notwithstanding differences in the contract laws of other Member States.

This is subject to certain qualifications, of course. First, professional financial market participants normally have access to professional legal advisers (both internal and external) to help ascertain the relevant law and to structure their transactions accordingly. We appreciate that in other areas of commercial life, notably, cross-border consumer transactions, there is unlikely to be a similar degree of access to professional legal support. Secondly, it remains the case that parties may need to check the laws of other Member States on matters such as insolvency law and property law to the extent that such laws would apply under conflict of laws rules, notwithstanding the chosen law of the parties. Thirdly, mandatory rules of a forum court may affect the enforceability of a contractual arrangement governed by the law of another member state, although typically in a cross-border financial transaction between professional market participants, these mandatory rules primarily concern insolvency law matters, as has already been mentioned.

At this stage, ISDA has no official view on the value of an optional instrument as far as financial market transactions are concerned. It is perhaps, however, fair to say that there is, for the reasons mentioned above, no clear need, as of yet, for such an instrument.

Furthermore, if there were such an instrument, although it is difficult to assess it in the abstract, it would be crucial that it not contain any mandatory rules that might defeat the otherwise legitimate expectations of sophisticated counterparties to a professional financial market transaction.

Without elaborating examples here (as we would, of course, leave this to national and comparative law experts), and with apologies for oversimplification, a rule (comparable to those that exist in certain Member States now) that permitted a party to be released from its contractual obligations in the event of undue economic hardship should not be included in the optional instrument, unless either (1) it would not apply to a transaction between sophisticated market participants (more generally regarding this, see further discussion below) or (2) at a minimum, it is possible to contract out of such rule (or, of course, simply to avoid the application of the instrument altogether, as suggested in the Action Plan, by opting in or out of it).

We appreciate that the elaboration of an optional instrument is only likely to occur, if ever, after the development of a common frame of reference.

4. The value of a common frame of reference

ISDA believes that there would be a value to the elaboration of a common frame of reference as we believe that this would aid (and, in fact, is virtually a pre-condition to) improving the coherence and consistency of the EC *acquis* in the area of contract law, as well as to improving the drafting of future EC legislation affecting contractual matters.

We also believe that such a common frame of reference would help to improve the consistency of national implementation of EC Directives, and it might even be beneficial in promoting uniform (or at any rate consistent) interpretation of EC legislation in national courts.

Of course, foregoing is subject to the assumption, which is a significant one, that the common frame of reference is of a high quality. This is only likely to be the case where sufficient resources are devoted to this task, and where:

- (a) the common frame of reference is carefully elaborated by appropriate national and comparative law experts, working closely together, and with relevant stakeholders; and
- (b) the process leading to the final adoption of such a common frame of reference is sufficiently deliberate, open and consultative.

The Action Plan gives no indication of how the foregoing task would be administered and what resources would be available for this purpose. It would, perhaps, have been premature in the Action Plan to speculate on this, but this issue is crucial to the achieving the intended objective of legal certainty, and will need to be considered carefully before the next stage in this process. Similar concerns would apply, of course, to the eventual elaboration, if it occurs, of an optional instrument.

Finally, in this context, we believe that the Commission and any other participants in the preparation of a common frame of reference must always bear in mind the importance of distinguishing between those rules and principles appropriate for commercial transactions between sophisticated market participants and those appropriate for transactions involving a consumer or small- or medium-sized enterprise (SME). Clearly, in the former case, mandatory rules should be kept to a minimum, if not entirely excluded, and freedom of contract should be supported as far as possible.

5. Promoting the elaboration of EU-wide standard contract terms

ISDA's mission has included from its inception in 1985 the development of standard contractual terms for privately negotiated derivative transactions, from its various standard form master agreements, to various product-specific booklets of definitions and standard confirmation templates for individual product types, to standard form collateral documentation for use in various jurisdictions. Most of ISDA's documents, including its most widely used ones, are designed for use in cross-border transactions² and may be used by non-members without restriction.

ISDA has published various User's Guides to its standard forms and regularly runs conferences and seminars on those documents, which are open to members, non-members, and other interested parties, including financial supervisors and other governmental officials. ISDA believes that having such standard forms available facilitates negotiation, enhances legal certainty, and promotes clarity and uniformity of market practice.³ We also believes that widespread use of its standard documents in the privately negotiated derivatives market has helped to avoid for that market many of the problems that the Commission's Action Plan seeks to address.

While promoting the benefits of its standard forms, ISDA has always made it clear that the documents may be customised by parties to meet their specific commercial, credit, legal, and other needs. Typically, ISDA documents are designed to facilitate such customisation, most famously, in the case of ISDA's Master Agreement, via the Schedule attached to the Master Agreement.

ISDA fully endorses the Commission's support in the Action Plan for the principle of contractual freedom and the desirability of minimising mandatory rules, especially as between sophisticated market participants.

ISDA has no objection, in principle, to the Commission acting, in effect, as a clearing house for information on standard contractual terms, although we do not believe that this is a necessary measure in the context of the professional financial markets. We would underline the concerns, which the Commission itself acknowledges in the Action Plan, that the Commission's role in this regard should not explicitly or implicitly appear to give approval to or favour one set of standard terms over a competing set intended for the same or overlapping markets.

The Commission must be strictly impartial in this regard, including as to the availability of the Commission's clearing house role to those associations who wish to make use of it. We also believe that the Commission should be careful not to become involved in elaborating standard contractual provisions for any of these markets. As the Commission suggests, the utility of this role should also be kept under review.

One final note in passing: In the Annex to the Action Plan, the Commission has summarised reactions to its Communication of November 2001 on European contract law. In paragraph 4.4.4 of the Annex, summarising responses from legal practitioners to Option IV in the November 2001 Communication, there is a reference to the ISDA Master Agreement, in the context of promoting legal certainty, as using English law.

While ISDA is pleased to be mentioned as publishing a document that promotes legal certainty, we wish to correct any misleading impression this comment (which was not made by us or on our behalf) might have left. ISDA's forms of Master Agreement currently provide for an election of either New York law or English law. The fact that the choice (in the principal standard forms) is currently limited to those jurisdictions simply reflects market practice in the privately negotiated derivatives market for cross-border transactions, and is certainly not intended to imply any endorsement of one legal jurisdiction (or legal tradition) over any other.

² We mention this specifically in the context of paragraph 84 of the Action Plan.

³ A full list of ISDA's standard form documents and other publications is available from its website at <http://www.isda.org>.

Indeed, certain ISDA forms are expressly governed by other laws, according to market needs, for example, ISDA has published a Japanese law governed collateral annex for use in documenting Japanese margin arrangements. ISDA is aware that sometimes its documents are adapted for use under other governing laws and has no objection to this, although ensuring that the document, as adapted, is appropriate to the particular jurisdiction concerned is the responsibility of the parties concerned and their legal advisers.

It is certainly possible that ISDA will itself, in the future, publish standard form documents that expressly contemplate the possibility of electing the law of Member States other than the United Kingdom. This will be driven by market demand rather than by any comparative law analysis, in relation to which ISDA has always been and remains strictly neutral.

6. Co-ordination with the consultation on the Rome Convention

For the reason mentioned in 1(d) above, ISDA underlines the importance of co-ordinating the Commission's consultation on the Action Plan with the consultation on the Rome Convention. We intend to respond to that consultation in due course. We note that the deadline for comments is 15 September 2003.

7. Conclusion

The Action Plan is ambitious. The stakes that it concerns are high. The contemplated timeframe is likely to be long and the likely available resources are unclear. But the Action Plan does mention some real problems that will need to be addressed in order to strengthen the internal market, and it does propose some concrete measures for debate.

ISDA wholeheartedly endorses the spirit underlying the Action Plan and the need for a continuing openness of dialogue and consultation on these issues. ISDA stands ready to provide any reasonable information or assistance to the Commission to ensure, in the context of the proposed initiatives, that the interests and needs of the European financial markets and, of course, in particular the European markets for privately negotiated derivatives are addressed.

Any questions or comments regarding our response to the Action Plan may be addressed to Peter Werner in ISDA's European Office at One New Change, London EC4M 9QQ (tel. +44 20 7330 3550; fax +44 20 7330 3555), e-mail: pwerner@isda-eur.org.

