

# ISDA®

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21 January 2011

Ladies and Gentlemen

### **Legislation on legal certainty of securities holding and dispositions**

The International Swaps and Derivatives Association (**ISDA**) is grateful for the opportunity to comment on the consultation document of the Internal Market Directorate General of the European Commission on “Legislation on Legal Certainty of Securities Holding and Dispositions” issued on 5 November 2010 (the **Consultation Document**). ISDA has had a longstanding interest in European and international efforts to strengthen the legal framework for securities held with an intermediary (often referred to as “intermediated securities” or, in the Consultation Document, “account-held securities”), including both the substantive law aspects and the critical private international law rules that determine whose substantive law applies.<sup>1</sup>

### **Information about the Respondent**

Paragraph 7 of the Consultation Document requests certain information from each respondent. The address of our European office appears above and our registration number in the relevant EU register is 46643241096-93. The addresses of our other offices, including our head office in

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<sup>1</sup> See, for example, our letters to the Commission of 23 June 2009 (on the Commission’s Consultation Document of 16 April 2009 on legislation on legal certainty of securities holding and disposition), 31 August 2004 (on the Commission Communication of 28 April 2004 entitled “Clearing and Settlement in the European Union – The Way Forward”) and 26 July 2004 (on the Hague Securities Convention), each of which is available on the ISDA website at [http://www.isda.org/c\\_and\\_a/collateral-Financial.html](http://www.isda.org/c_and_a/collateral-Financial.html). ISDA also actively participated in the consultation process leading to the adoption of the Hague Securities Convention and the Geneva Securities Convention, in each case attending expert working group meetings and diplomatic sessions as an observer and submitting written consultation responses, each of which is also available on the ISDA website. We have also on various occasions informally discussed these issues with Commission officials and participated in meetings with national officials of various EU member states on issues relating to account-held securities.

New York, may be found on our website at <http://www.isda.org> through the “Contact us” link at the top of the home page.

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 has 800 member institutions from 54 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

More than half of ISDA members are based in the European Union and neighbouring countries and most of the other members are active participants in the European financial markets as dealers, service providers or end users of derivatives. 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.

As an industry association, ISDA is not an account provider. Many of its members act as account providers, but ISDA's mission does not encompass those activities. ISDA is concerned, as noted above, with the activities of its members in the markets for privately negotiated derivatives transactions, either as principal (as dealer or end-user) or as agent for other market participants. All of ISDA's members use account providers and, as noted below, the transfer of securities held by intermediaries through securities settlement systems is an important aspect of the derivatives markets, principally in relation to the physical settlement of securities-related derivatives transactions and the delivery and return of financial collateral in the form of securities.

ISDA's membership encompasses members carrying out European regulated activities, including banking and investment services, as well as many end-users of derivatives, who are not themselves regulated<sup>2</sup> but are protected by financial regulation. Further details of ISDA's membership structure, including a list of the names of its primary, associate and subscriber members, is available from our website at <http://www.isda.org> through the “Membership” link on the left side of the home page.

## **Overview**

We welcome the Commission's continued engagement with industry on these issues and its determination to bring greater clarity to and promote convergence of the substantive and conflict of laws rules applicable to account-held securities. We are aware that a number of other trade associations and other bodies will be responding in detail to the Consultation Document, as we

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<sup>2</sup> i.e. not regulated in relation to their derivatives activities, although many end-users may be regulated as to part or all of their other business activity, for example, insurance companies, pension fund trustees and administrators, licensed public utilities and so on. Many end-users are, of course, large industrial and commercial corporations using derivatives to manage interest rate, currency and other business-related risks.

have participated in industry discussions concerning the Commission’s current consultation process on these issues.

### **Scope of our response**

Given our focus on the privately negotiated derivatives industry, we will confine our comments to the aspects of the proposals that will have the most direct impact on derivatives transactions relating to account-held securities, including physically-settled derivatives transactions involving delivery of account-held securities and credit support arrangements relating to derivatives master netting agreements, such as the 1992 and 2002 versions of the ISDA Master Agreement, under which account-held securities are delivered as financial collateral. We will therefore not attempt to answer every question, but focus on certain questions and on certain key aspects of the proposals.

Specifically, we will respond to the aspects of the proposals that directly relate to the legal analysis and effects of the transfer and holding of the securities, as these are the aspects of most immediate relevance to physical settlement of securities-related derivatives transactions and the delivery of securities as financial collateral.

The Consultation Document deals with a number of other important, if not crucial, aspects of the legal and regulatory framework for securities holding and disposition via intermediaries. If we do not deal with an issue, it is not because we view it as unimportant but because we wish to focus on our areas of expertise as a trade association focused on privately negotiated transactions in derivatives and defer to other interested stakeholders with a more explicit focus and expertise on those issues.

Thus, we do not comment, other than in passing, on the aspects of the proposals dealing with the transmission to an “ultimate account holder” of rights in securities and the exercise of those rights by the ultimate account holder, although clearly those are difficult and important issues.

Other than in one important respect (relating to whether all account providers should be regulated), we also do not discuss the questions raised by the Consultation Document in relation to the business of providing and maintaining securities accounts, including provisions seeking to impose liabilities on account providers in certain circumstances (most notably in the case of shortfall in the account provider’s own holding of a particular security) and in relation to fees that may be charged by account providers. Many of ISDA’s members are account providers (and all of them are account holders), but as noted above (under “Information about the Respondent”) the activity of providing and maintaining accounts does not fall within the scope of ISDA’s work as the principal international trade association concerned with the privately negotiated derivatives market. We therefore defer to other more directly concerned stakeholders in relation to these issues.

## **Summary of our comments**

In brief, our comments are as follows:

1. We strongly welcome the aims of the Consultation Document. We believe that this is a crucial initiative for the European Union, necessary to build and strengthen and to make more efficient and resilient the internal market for financial services.
2. We support the functional and jurisdiction-neutral approach proposed by the Commission in the Consultation Document.
3. We do not believe that it is necessary or appropriate for a European instrument on the substantive law aspects of account-held securities to require, as a condition of the application of substantive legal principles, that each account provider should be regulated under Directive 2004/39/EC on markets in financial instruments (**MiFID**). This undermines legal certainty and would deprive an account holder of the protection of the proposed regime, possibly in circumstances when it most needs that protection. It also confuses the purpose of the regime. The regulation of entities carrying on the business of providing and maintaining accounts (and not all account providers, as explained in the Annex in more detail, are carrying on such a business) should properly be dealt with by an instrument directly concerned with regulation of the activity of financial market participants.
4. We strongly urge the Commission to ensure that the substance of the European legal framework for account-held securities reflected in its eventual legislative proposal conforms to the principles set out in the Geneva Securities Convention. We note that the Consultation Document states this as an aim, but we also note that the detail of the proposals varies from the principles in the Geneva Securities Convention in several important respects. This inevitably detracts from the goal of ensuring that the European legal framework for account-held securities (referred to as “account-held securities” in the Consultation Document)
5. We urge the Commission to find a constructive solution to the current impasse within the European Union in relation to the Hague Securities Convention so that the European rules for determining the law applicable to rights in account-held securities are, as far as possible, consistent with the global standard established by the Hague Securities Convention. If it is not possible to find such a solution, we at any rate urge the Commission to formulate a conflict of laws rule that provides greater *ex ante* certainty than the rule set out in the proposal and is, as far as possible, as close to the global standard set out in the Hague Securities Convention as possible.
6. In relation to the scope of a future European instrument (Regulation or Directive) on account-held securities, we would urge the Commission to ensure that the scope is sufficiently broad that it can accommodate the full range of securities issued, held and transferred in the financial markets, with sufficient flexibility to encompass easily foreseeable evolution of the concept of a “security”, but also to ensure that it is not overly broad so as to encompass, for example, privately negotiated derivatives transactions,

which are not securities and which are not issued, held or transferred in a manner comparable to account-held securities.

In the Annex to this letter, we set out our answers to specific questions raised by the Consultation Document of particular importance to the derivatives industry. We would be pleased to meet with you to continue our discussions with you regarding the issues arising out of the Consultation Document. We look forward to receiving and will study with close attention any more detailed proposals that emerge as a result of this consultation, including an eventual draft Directive or Regulation.

In the meantime, please do not hesitate to contact either of the undersigned if we can provide further information about the privately negotiated derivatives market or other information that would assist the Commission's work in relation to account-held securities.

Yours faithfully

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## ANNEX

**Answers to selected questions in the Consultation Document:<sup>3</sup>**

- Q1** *Do you agree that the envisaged legislation should cover the objectives described above [in part 1 of the Consultation Document]? If not, please explain why. Are any aspects missing (please consider also the following pages for a detailed description of the content of the proposal)?*

We fully support the principal objective of the proposed legislation to create a common legal framework governing the holding and transfer of account-held securities.<sup>4</sup> In the derivatives markets, physical settlement of securities-related derivatives transactions and delivery of securities collateral occur almost exclusively through intermediaries. Most EU jurisdictions, however, do not appear to have fully modernised their legal framework for the transfer and holding of securities in this form, attempting to apply by analogy legal concepts developed long ago for paper-based transfer of securities in physical form.

This reflects the position globally, and it was this urgent need to modernise the legal framework for the holding and transfer of account-held securities that was, of course, the impetus behind the development of the Geneva Securities Convention.

Although, as already mentioned, we do not comment generally in this paper on the company law aspects (as opposed to the substantive property law and conflict of laws aspects) of the proposal, we can confirm that the current lack of a harmonised rule in the EU concerning whom the issuer of securities must recognise as the legal holder of securities does not create a particular problem from a derivatives market perspective.

For the reasons discussed below in response to Question 41, we do not believe it is necessary or appropriate to legislate in this instrument for all account providers to be subject to a detailed authorization and supervision framework such as the one provided by MiFID.

The conflict of laws rules applicable to the holding and transfer of account-held securities in the proposed legislation, as well as the comparable rules in the Settlement Finality Directive (**SFD**) and the Financial Collateral Arrangements Directive (**FCAD**), should be reformed so that they are clear and provide *ex ante* certainty to market participants as to the applicable. The rules should also be brought into line, as far as possible, with the global standard created by the Hague Securities Convention.

- Q7** *The Geneva Securities Convention provides for a global harmonised instrument regarding the substantive law (= content of the law) of holding and disposition of securities, covering the same scope as those parts of the present outline dealing with this subject. Most EU Member States and the EU itself have participated in the negotiations*

<sup>3</sup> The reasons for answering only certain of the questions posed in the Consultation Document are explained in the text of the letter to which this Annex is attached.

<sup>4</sup> For the reasons given in the text of the letter to which this Annex is attached, we do not comment on the aspects of the proposals relating to the processing of rights flowing from securities held through securities accounts.

*of this Convention. Both the present approach and the Convention are compatible with each other.*

- *If applicable, does your business model comprise securities holdings or transactions involving non-EU account holders or account providers?*
- *Is it, in your opinion, important to achieve global compatibility regarding the substantive law of securities dispositions, or would EU-wide compatibility suffice?*

We strongly endorse the goal of ensuring that the proposed EU legislation is not merely compatible with but as far as possible conforms to the principles set out in the Geneva Securities Convention. We believe that the detail of the proposals varies from the principles in the Geneva Securities Convention in several important respects, and we strongly urge the Commission to review its proposals against the background of the Geneva Securities Convention with a view to ensuring that the emerging EU legal framework for account-held securities is in line with the global standard reflected in the Geneva Securities Convention.

- Q17 *Will a Principle along the lines set out above [Principle 9], under which the applicable law would need to afford an inferior priority to interests created under a control agreement, be appropriate and justified against the background that control agreements are not ‘visible’ in the relevant securities account? If not, please explain why.*

We can see no policy basis for according a higher priority to earmarking than to a control agreement, as we do not believe that earmarking is any more “visible” to a potential creditor than the existence of a control agreement. First, there is a lack of clarity in the proposal as to what constitutes an “earmark” and how that should be manifested operationally. When that is clarified, it will then be necessary to investigate whether all account providers will have the necessary technology to give effect to an earmark on whatever basis is eventually prescribed by the legislation.

Assuming, however, based on the definition that it is an “entry” in the relevant account, this will not be visible in any meaningful sense to a prospective secured creditor of the account holder. The prospective creditor will need to make enquiry of the account provider as to the security status of the account. Given that a control agreement by definition requires the participation of the account provider, the account provider will be just as aware of the control agreement as of the existence of an earmark. The prospective creditor will need to rely on the account provider in either case to determine whether or not the account is affected by a prior security.

Accordingly, we urge that security interests perfected by earmarking or a control agreement should rank in accordance with the chronological order in which they occur (“first in time”), with equal priority (apart from timing) accorded to an earmark and a control agreement.

- Q20 *Would a Principle along the lines described above [Principle 10] pave the way for the national legal frameworks to effectively protect client securities in case of the insolvency of an account provider?*

The two elements of Principle 10, set out in paragraphs 10.1(1) and 10.1(2) of the Consultation Document, are among the most important principles that the proposed legislation should embody. Of course, many jurisdictions already provide such protections, but a common approach, uniform rules across Europe and greater clarity as to the existence and operation of such rules are necessary to ensure the integrity of systems for intermediation of securities holding.

In relation to the principle that securities and account-held securities held by an account provider for its account holders should be protected from the insolvency of the account provider, this reflects the normal expectation of account holders. It is important, however, that the legal reality should match the legitimate market expectation in this respect.

- Q22 *Should the sharing of a loss in securities holdings (occurring, for example, as a consequence of fraud by the account provider) be left to national law? Would you prefer a harmonised rule, following the pro rata principle or any other mechanism?*

In relation to the principle in paragraph 10.1(2) of the Consultation Document that there should be a mechanism for dealing with a shortfall of securities or account-held securities held by an insolvent account provider, this is indisputable. We believe that a *pro rata* sharing rule is the most equitable solution and is compatible with Article 26(2)(b) of the Geneva Securities Convention. We also believe that the single market in Europe would benefit from a common approach to this issue, rather than leaving the matter to national law.

- Q24 *Would a Principle along the lines described above [Principle 12] provide Member States with a framework allowing them, in combination with the envisaged Principle on shared functions [Principle 2], to effectively reflect operational practice regarding attachments in your jurisdiction? If not, please explain why.*

Principle 12 is another important principle that should be part of a modern legal framework for systems for the holding and transfer of securities through intermediaries. Once again, the market expectation is that such attachments will not occur, and it is also clear that any such attachment would create operational difficulty and potentially harmful uncertainty regarding the integrity of a chain of accounts held through intermediaries. The possibility of an upper-tier attachment occurring creates legal uncertainty and should be clearly excluded.

- Q25 *Have you ever encountered, in your business practice, attempts to attach securities at a tier of the holding chain which did not maintain the decisive record? If yes, please specify.*

We are not aware of evidence that upper-tier attachments or attempted upper-tier attachments occur frequently, but, for the reasons given above, the possibility of an upper-tier attachment occurring should be clearly excluded.

- Q26 *Would the proposed framework [Principle 13] for protecting client accounts be sufficient? Should the presumption that accounts opened by an account provider with*

*another intermediary generally contain client securities become a general rule? If not, please explain why.*

We strongly agree that the framework should provide that creditors of an account provider should not be able to attach securities credited to an account maintained by the account provider for one or more of its clients. This is a fundamental principle and one that accords with current market expectations of account holders. It is important that legal reality ensures that this expectation is not frustrated. We do not, however, think it is necessary to go as far as creating a statutory presumption that any account maintained by an account provider with a second account provider is a client account. We believe that this is something that can be left to current practice of account providers and national law of each EU Member State.

- Q27 *Would a Principle along the lines described above [Principle 14] allow for a consistent conflict-of-laws regime? If not: Which part of the proposal causes practical difficulties that could be addressed better?*
- Q28 *Would the mechanism of communicating to the client [Principle 14], whether the head offices or a branch (and if a branch, which one) is handling the relationship with the client, add to ex-ante clarity? Is it reasonable to hold the account provider responsible for the correctness of this information? If applicable, would any negative repercussions on your business model occur?*

We deal with Questions 27 and 28 together. We believe that the European conflict of laws rules for determining the law applicable to the issues set out in Paragraph 14.1(3) of the Consultation Document should conform to the approach taken in the Hague Securities Convention for two important reasons: (a) the Hague Securities Convention approach provides *ex ante* certainty, whereas the proposal in the Consultation Document does not, and (b) adhering to the Hague Securities Convention approach would bring the EU in line with a global standard, which would radically diminish legal uncertainty in relation to one of the most difficult areas of private international law affecting the financial markets.

We do not believe that the opponents of the Hague Securities Convention within the EU have made a convincing case against it as a matter of principle or of policy. We note that the EU and the then 15 Member States of the EU unanimously supported the final text of the Hague Securities Convention when it was originally signed in 2002. We would urge the Commission to reconsider with the Member States whether the objections that have been raised may be addressed in some way without undermining the basic approach of the Hague Securities Convention.

If, however, it remains not possible to achieve political consensus on adoption of the Hague Securities Convention by the EU and its Member States, the proposal by the Commission should be reconsidered with a view to ensuring that (a) it provides *ex ante* certainty and (b) is appropriate for both indirect holding and direct holding/transparent systems. In relation to the latter, we believe that other respondents more directly concerned with that distinction are responding in detail, and so we will defer to those responses, merely noting that this remains an area of uncertainty in the proposal.

In relation to the goal of providing *ex ante* certainty, we disagree with the premise that it is “admittedly rare” for there to be uncertainty in practice as to where account-held securities are “located”. There is, in fact, material legal uncertainty as to how this is determined, and this uncertainty is only likely to increase over time as the management of account and client relationships becomes ever more virtual.

The determination of location in relation to an intangible relationship (which is the nature of an account relationship) relies on privileging one or more physical aspects of the operation of an account provider (for example, the location of a building where a branch is established) over others and then artificially locating the intangible relationship where that physical aspect is manifest. There are many possible choices for such physical connecting factors (location of branch building, location of office where personnel are located who manage the account relationship, location of call centre, location of corporate headquarters of the account provider, location of relevant systems infrastructure and so on) and the full list of choices will vary from account provider to account provider.

Furthermore, those physical aspects in relation to a single account provider will evolve over time as operations evolve, including the evolution of shared functions and the evolution of technology, including client-facing technology. A rule based on location, such as the rules contained in the SFD and FCAD, is clearly inadequate and will become steadily more so as the markets continue to evolve. It was the inadequacy generally of location-based approaches (which are conceptually incoherent, given the intangible nature of an account relationship) to these issues, as well as the desire for harmonisation of a global standard, that, of course, led to the development of the Hague Securities Convention.

The approach proposed in the Consultation Document fails to recognise the nature of the problem or to advance a solution that addresses the need for *ex ante* certainty. This is not cured by the requirement that the account provider should communicate the location of the branch to the account holder, unless that communication may be deemed to be conclusive by the account holder and any interested creditor of the account holder. If it were to be deemed conclusive, this might provide a solution that would provide *ex ante* certainty. Any negligent or abusive use of this communication mechanism by an account provider could be sanctioned by appropriate regulation without undermining its conclusive nature for substantive law purposes.

We agree that the conflicts of law rules in the SFD and the FCAD should be brought into line with the conflicts of law rule to be set out in the proposed legislation, preferably amended to provide *ex ante* either along the lines proposed above or in some comparable way.

- Q29 *The Hague Securities Convention provides for a global harmonised instrument regarding the conflict-of-law rule of holding and disposition of securities, covering the same scope as the proposal outlined above and the three EU Directives. Most EU Member States and the EU itself have participated in the negotiations of this Convention. The proposed Principle 14 differs from the Convention as regards the basic legal mechanism for the*

*identification of the applicable law. However, the scope of Principle 14 is the same as the scope of the Convention: property law, collateral, effectiveness, priority. Do you agree that this will facilitate the resolution of conflicts with third country jurisdictions? If not, please explain why.*

We have explained above our concern regarding the Commission's proposal. If it were amended as we propose (or in some other way that provides *ex ante* certainty), that would be a tremendous improvement, but the lack of harmonisation with the approach adopted elsewhere in the world would be regrettable and, from a policy perspective, seems unnecessary. There would be a real risk of conflicting decisions in the courts of different jurisdictions on the same question. It would therefore be preferable to persevere with a resolution of any current concerns about the Hague Securities Convention with a view to bringing the EU in line with a harmonised global rule.

- Q41 *Should the status of an account provider be subject to a specific authorisation? If not, please explain why.*
- Q42 *If yes, do you think that MiFID would be an appropriate instrument to cover the authorisation and supervision of account providers.*

We deal with Questions 41 and 42 together. We do not believe that it is necessary or appropriate for a European instrument on the substantive law aspects of account-held securities to require, as a condition of the application of substantive legal principles, that each account provider should be regulated under MiFID. This undermines legal certainty and would deprive an account holder of the protection of the proposed regime, possibly in circumstances when it most needs that protection. It also confuses the purpose of the regime. The regulation of entities carrying on the business of providing and maintaining accounts (and not all account providers, as explained in the Annex in more detail, are carrying on such a business) should properly be dealt with by an instrument directly concerned with regulation of the activity of financial market participants.

To be clear, we fully support the appropriate regulation of account providers who are providing accounts in the course of carrying on a business of providing and maintaining accounts as part of the investment activity of "safekeeping and administration of financial instruments". To this end, we agree that article 5 of MiFID provides an appropriate basis for a suitable regulatory regime in this regard. But we note that not all account providers are necessarily conducting such a business, for example, a trustee, an agent for an issuer, a person providing an account in the course of a business other than investment business or a company providing an account for another member of its corporate group.

Furthermore, even if an account provider should be authorised but is not, the substantive law treatment of account-held securities credited to an account maintained by the account provider should remain the same. Failure by the account provider to obtain the necessary authorisation may be addressed by appropriate regulatory sanctions on the account provider, without creating legal uncertainty for or otherwise prejudicing the rights of its account holders.

**Q43** *Do the terms used in this glossary [in part 22 of the Consultation Document], facilitate the understanding of the further envisaged principles? If no, please explain why.*

We believe that the definition of “securities” should be amended to conform it to the definition in the Geneva Securities Convention. We do not think that the definition of “financial instrument” in Annex 1, Section C of MiFID is an appropriate basis for the definition given that this definition was developed for an entirely different purpose, namely, the regulation of investment services relating to financial instruments. In particular, we do not believe that it should encompass privately negotiated derivatives transactions (which the MiFID definition does, at least in part, although it does not encompass all privately negotiated derivatives transactions<sup>5</sup>). Such transactions are not securities nor are they issued, held or transferred in a manner comparable to account-held securities.

The definition of “securities account” may require amendment to reflect a more accurate treatment of direct holding/transparent systems. We understand other associations are commenting on this in more detail.

If our response to Questions 41 and 42 are taken into account, the definition of “account provider” will require appropriate adjustment. A more neutral and functional definition would, in our view, be more appropriate.

We suggest that the definitions of “crediting” and “debiting” should be brought in line with the Geneva Securities Convention.

It may be considered that the definitions of “acquisition” and “disposition” are not necessary.

**Q44** *Would you add other definitions to this glossary?*

We suggest that consideration be given to adding a definition of “rules”, along the lines of the definition of “uniform rules” in Article 1 of the Geneva Securities Convention, adding a definition of “maintains securities accounts” and adding a related definition of “safekeeping functions”. In each case, the definition should be neutral and functional, in accordance with the Commission’s general approach in the Consultation Document.

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For example, it does not encompass certain physically settled derivatives contracts on precious metals and other commodities and does not encompass certain “contracts for differences”, which are cash-settled derivatives contracts, where the underlying risk is not within the scope of MiFID, for example, longevity risk.