INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW
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UNIDROIT COMMITTEE OF GOVERNMENTAL EXPERTS FOR THE PREPARATION OF A DRAFT CONVENTION ON HARMONISED SUBSTANTIVE RULES REGARDING INTERMEDIATED SECURITIES
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COMMENTS BY GOVERNMENTS AND INTERNATIONAL ORGANISATIONS

(Comments by ISDA)

ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry (more than 670 institutions from 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. A significant proportion of these transactions are settled by delivery of, hedged with or collateralized by delivery of securities held with intermediaries. 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.

We wish to stress once again to the experts who will be attending the March 2006 Session the importance to the international financial markets of the issues currently being addressed by this UNIDROIT Committee of Governmental Experts ("CGE").

We will not repeat the comments made in our prior letters, many of which continue to apply, particularly those in our letter of 31 March 2005. We would, however, like to reiterate the particular importance to the financial markets of the issues addressed in Article 20 (Set-off) and in Chapter VII (Special Provisions with Respect to Collateral Transactions).

We also believe that the CGE should consider strengthening protection of close-out netting in the Draft Convention. Many countries have introduced legislation to permit or, where already permitted, strengthen close-out netting financial transactions, recognising the importance of close-out netting to reducing counterparty risk and therefore systemic risk within the financial markets. But there are a number of jurisdictions where there is no netting legislation or close-out netting is only permitted on a partial or highly restricted basis.

This is directly relevant to the issues in Chapter VII of the Draft Convention for two reasons. First, most financial collateral arrangements covering financial transactions traded privately between market counterparties apply to the net exposure of the party that is "in the money" to the other party. This net exposure, of course, varies between collateral valuation dates with movements in market values of both the financial transactions that are collateralized and the financial collateral provided. It is important to the soundness of the markets that there be legal certainty as to the enforceability of this net exposure, otherwise parties may find themselves seriously undercollateralized in the event of the insolvency of a collateral provider. Also, as we discuss in our letter of 31 March 2005 (and in prior submissions to Unidroit on these issues), title transfer financial collateral arrangements, which are widely used in the financial markets (and are, for example, the predominant form of financial collateral arrangement in Europe), generally rely on a close-out netting mechanism for their effectiveness.

We are currently revising our Model Netting Act (originally published in 1996 and revised in 2002). The new version will be published shortly, together with an Explanatory Memorandum which is intended as guidance not only to the substantive provisions of the 2006 Model Netting Act, but also, in particular, to legislators in civil code jurisdictions to show how the 2006 Model Netting Act, while having the appearance of a common law statute, may provide helpful guidance for implementing or amending netting legislation in a country with a civil code legal tradition. We would be happy to provide these materials to the CGE when they are available, which we expect them to be shortly.

A couple of other thoughts ahead of the March 2006 Session are set out below. We would be happy to discuss these and any other issues (including those in our letter of 31 March 2005) in more detail at the March 2006 Session or on any other occasion with members of the CGE.

1. As we mentioned in our letter of 31 March 2005, we think it would be helpful to include a definition of "person" in the Draft Convention in order to clarify that natural persons are included, as well as legal persons. Account holders who are natural persons should be assured the same protections under the Draft Convention as corporate account holders.

2. We would also like to comment on the definition of "securities" in the Draft Convention. As we mentioned in our letter of 31 March 2005, we believe that, as far as possible, the definitions in the Draft Convention should be conformed to those in the Hague Securities Convention [1]. The Hague Securities Convention deals with the fundamental threshold question of which law applies to the issues set out in Article 2(1) of the Hague Securities Convention in relation to intermediated securities. The Draft Convention deals with substantive law issues relating to intermediated securities. We acknowledge that the Draft Convention deals with some issues that do not fall within Article 2(1) of the Hague Securities Convention. Nonetheless, we believe the legal certainty will be strengthened by reducing inconsistencies between the definitions used in the two international instruments.

   This is particularly true in relation to the key definition of "securities". At the moment, the only difference between the two definitions is the inclusion of the word "transferable" in the Draft Convention before the words "financial instruments". The word "transferable" does not appear in the definition of "securities" in the Hague Securities Convention. We strongly recommend deleting this word. We do not see that it serves any useful purpose in the definition, other than to introduce a potential qualification, the meaning of which is uncertain, on the scope of the Draft Convention.

We understand that it has been suggested that the definition of "securities" should be expanded to make explicit reference to derivative transactions. It seems to us that the current definition is already broad enough to encompass (a) a security with an embedded derivative (for example, an equity index-linked debt security) and (b) any derivative that is documented and traded as a security (for example, many warrants to subscribe for or purchase shares, which are essentially options in the form of securities). In other words, the definition is already broad enough to cover derivatives that are created and traded in the form of a security. On the other hand, a privately negotiated (or "over-the-counter") derivative transaction is a bilateral contractual arrangement that does not involve the creation or trading of a security. We do not believe that the definition of "security" was intended to capture such transactions, and we do not believe that it would be helpful to the financial markets to expand this definition to cover such transactions.

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[1] 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).