



**UNIDROIT COMMITTEE OF GOVERNMENTAL EXPERTS FOR  
THE PREPARATION OF A DRAFT CONVENTION ON  
SUBSTANTIVE RULES REGARDING INTERMEDIATED  
SECURITIES  
Third session  
Rome, 6/15 November 2006**

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***COMMENTS BY GOVERNMENTS  
AND INTERNATIONAL ORGANISATIONS***

*(Comments by the International Swaps & Derivatives Association, Inc., ISDA)*

[...] Ahead of the November 2006 Session, we wish to make the comments below. To illustrate how these comments could be taken into account in the text of the draft Convention, we attach a proposed revision to the definition of "collateral agreement" in Article 1, revisions to Chapter V of the draft Convention and the text of a proposed additional Chapter VI.

**1. Set-off and collateral**

As we have indicated in our prior correspondence in relation to this project, the provisions of the draft Convention dealing with set-off and collateral are of particular importance to the international derivatives and related financial markets. In reviewing the current draft Convention, we have therefore focused in particular on the Articles of Chapters I to IV that deal with collateral agreements, Article 14 (Set-off) and Chapter V.

We are generally happy with these provisions, as far as they go, subject to certain comments in our prior comment letters which have not yet been addressed. We would, however, like to take this opportunity to urge you to consider our proposals below to strengthen the draft Convention in relation to title transfer collateral arrangements and close-out netting.

**2. Title transfer collateral agreements**

A large proportion of collateral arrangements globally are based on transfer of title rather than the creation of a security interest. In fact, in some markets, such as Europe, it is the predominant form of collateral arrangement for cross-border derivative transactions. It is also the legal basis for the international securities lending and repo markets.

We have therefore stressed from our earliest correspondence with you on this project the importance of ensuring that title transfer collateral arrangements are properly taken into account in your work. However, the definition of "collateral agreement" in the draft Convention is clearly limited to collateral agreements based on creation of a security interest. Article 24(3) refers to netting in this context, but only in relation to "collateral agreements" as defined, that is, collateral based on creation of a security interest.

We therefore make the following proposals, which we urge the Committee of Governmental Experts to consider:

- (a) amending the definition of "collateral agreement" in Article 1 to "security collateral agreement", with corresponding changes to the other references to "collateral agreement" in Chapters I to IV;
- (b) a few amendments to Chapter V, explained in more detail below;
- (c) the addition of a new Chapter VI dealing with title transfer collateral arrangements and the enforceability of close-out netting.

### **3. Amendments to Chapter V of the draft Convention**

The amendments we have proposed to Chapter V are primarily to clarify that it relates only to security collateral agreements. We have, however, suggested deleting some redundant wording in Article 25(2), in light of the definition in Article 1(l) of the draft Convention of securities "of the same description".

The one substantive change we are proposing to Chapter V is to Article 26(1)(a), where we strongly urge that the language in square brackets be retained and the words "to the extent permitted by the applicable law as determined under private international law rules of the forum" be deleted. Provisions in collateral agreements increasing the collateral agreement in certain objective circumstances, such as a ratings downgrade in relation to the collateral provider, are absolutely commonplace in the international financial markets, and are an important tool of prudent risk management. It is important that the enforceability of such provisions be established with the same high degree of legal certainty that should apply to the collateral agreement as a whole.

As such provisions are also common in title transfer collateral agreements, we have included a comparable provision in our proposed Chapter VI.

### **4. Proposed Chapter VI: title transfer collateral arrangements and close-out netting**

Our proposed Chapter VI has a dual purpose. It is intended to strengthen the legal certainty of title transfer collateral arrangements and, more generally, of close-out netting under netting agreements, whether those netting agreements are collateralised or not.

The provisions dealing with title transfer collateral arrangements are closely modelled on the comparable provisions of the European Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements (the European Collateral Directive), which clearly and separately addresses both security financial collateral arrangements and title transfer financial collateral arrangements. Our proposed Article 30, for example, is based closely on Article 6 of the European Collateral Directive. We trust that the European members of UNIDROIT will therefore be entirely familiar and comfortable with these provisions, and that this will help the other members of UNIDROIT also to get comfortable with these provisions in a relatively short period of time.

Since title transfer collateral agreements are typically based on the operation of a close-out netting provision, we have made further proposals to strengthen legal certainty in relation to close-out netting. Given the effectiveness of close-out netting in reducing credit risk in the derivatives and related financial markets, as highlighted, for example, in studies of credit risk in the market by the Bank for International Settlements, we believe that the opportunity should be taken in the draft Convention to strengthen close-out netting under netting agreements, whether or not the netting agreement is supported by a collateral arrangement.

In our letter of 24 February 2006, we called for a further strengthening of close-out netting in the draft Convention, and we referred to our then prospective revision of our Model Netting Act. The revised Model Netting Act was published in March 2006, together with a Memorandum on the Implementation of Netting Legislation – A Guide for Legislators and Other Policy-Makers (March

2006), and so in preparing our proposed Chapter VI to the draft Convention, we have had regard to the principles reflected there. We have also had regard once again to comparable provisions of the European Collateral Directive, but, in each case, we have attempted to accommodate those principles and comparable provisions to the style and approach of the draft Convention.

**Appendix****AMENDMENTS proposed by the International Swaps & Derivatives Association, Inc. to  
the Preliminary draft Convention on Substantive Rules Regarding Intermediated  
Securities****(as adopted by the Committee of Governmental Experts at its second session,  
held in Rome, 06-14 March 2006)****(UNIDROIT 2006 – Study LXXVIII – Doc. 42 – March 2006)***Article 1**[Definitions]*

...

(r) "collateral taker" means a person to whom a security interest in intermediated securities is granted;

(s) "collateral provider" means an account holder by whom a security interest in intermediated securities is granted;

(t) "security collateral agreement" means an agreement between a collateral provider and a collateral taker providing (in whatever terms) for the grant of a security interest in intermediated securities.<sup>1</sup>

**CHAPTER V – SPECIAL PROVISIONS WITH RESPECT TO  
SECURITY COLLATERAL AGREEMENTS TRANSACTIONS***Article 23**[Scope and interpretation in Chapter V]*

1. - This Chapter applies to collateral arrangements under which a collateral provider delivers intermediated securities under a security collateral agreement to a collateral taker under Article 5(2) or Article 5(3) in order to secure the performance of any existing or future obligation of the collateral provider or a third person.

2. - In this Chapter –

(a) "*enforcement event*" means, in relation to a collateral agreement, an event on the occurrence of which, under the terms of that collateral agreement, the collateral taker is entitled to enforce its security;

(b) "*collateral securities*" means intermediated securities delivered under a collateral agreement;

(c) "*secured obligations*" means the obligations secured by a security collateral agreement.

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<sup>1</sup> References to "collateral agreement" in Chapters I to IV of the preliminary draft Convention should be replaced by "security collateral agreement".

*Article 24*

*[Enforcement of security collateral agreements]*

1. - On the occurrence of an enforcement event, the collateral taker may realise the collateral securities provided under a security collateral agreement:

(a) by selling them and applying the net proceeds of sale in or towards the discharge of the secured obligations; or

(b) by appropriating the collateral securities as the collateral taker's own property and setting off their value against, or applying their value in or towards the discharge of, the secured obligations, provided that the security collateral agreement provides for realisation in this manner and specifies the basis on which collateral securities are to be valued for this purpose.

2. - Collateral securities may be realised under paragraph 1:

(a) subject to any contrary provision of the security collateral agreement, without any requirement that:

(i) prior notice of the intention to realise shall have been given;

(ii) the terms of the realisation be approved by any court, public officer or other person; or

(iii) the realisation be conducted by public auction or in any other prescribed manner; and

(b) notwithstanding the commencement or continuation of an insolvency proceeding in respect of the collateral provider or the collateral taker.

3. - A security collateral agreement may provide that, if an enforcement event occurs before the secured obligations have been fully discharged, either or both of the following shall occur, or may at the election of the collateral taker occur, whether through the operation of netting or set-off or otherwise:

(a) the respective obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value or are terminated and replaced by an obligation to pay such an amount;

(b) an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party.

4. - This Article is without prejudice to any requirement of the domestic non-Convention law to the effect that the realisation or valuation of collateral securities or the calculation of any obligations must be conducted in a commercially reasonable manner.

*Article 25*

*[Right to use collateral securities under a security collateral agreement]*

1. - If and to the extent that the terms of a security collateral agreement so provide (or, where collateral securities are delivered to the collateral taker under Article 5(2), if and to the extent that the terms of the security collateral agreement do not provide otherwise), the collateral taker shall have the right to use and dispose of the collateral securities as if it were the owner of them (a "*right of use*").

2. - Where a collateral taker exercises a right of use, it thereby incurs an obligation to replace the collateral securities originally transferred (the "*original collateral securities*") by transferring to the collateral provider, not later than the discharge of the secured obligations, securities of the same issuer or debtor, forming part of the same issue or class and of the same

nominal amount, currency and description or, where the security collateral agreement provides for the transfer of other assets [following the occurrence of any event relating to or affecting any securities provided as collateral], those other assets.

3. - Securities transferred under paragraph 2 before the secured obligations have been fully discharged:

(a) shall, in the same manner as the original collateral securities, be subject to a security interest under the relevant security collateral agreement, which shall be treated as having been created at the same time as the security interest in respect of the original collateral securities was created; and

(b) shall in all other respects be subject to the terms of the relevant security collateral agreement.

4. - The exercise of a right of use shall not render invalid or unenforceable any right of the collateral taker under the relevant security collateral agreement.

#### *Article 26*

##### *[Top-up or substitution of collateral]*

1. - Where a security collateral agreement includes:

(a) an obligation to deliver collateral securities or additional collateral securities in order to take account of changes in the value of the collateral provided under the security collateral agreement or in the amount of the secured obligations [, in order to take account of any circumstances giving rise to an increase in the credit risk incurred by the collateral taker] or, to the extent permitted by the applicable law as determined by the private international law rules of the forum, in any other circumstances specified in the security collateral agreement; or

(b) a right to withdraw collateral securities or other assets on providing collateral securities or other assets of substantially the same value,

the provision of securities or other assets as described in paragraph (a) and paragraph (b) shall not be treated as invalid, reversed or declared void solely on the basis that they are provided during a prescribed period before, or on the day of but before, the commencement of an insolvency proceeding in respect of the collateral provider, or after the secured obligations have been incurred.

#### *Article 27*

##### *[Declarations in respect of Chapter V]*

1. - A Contracting State may declare that this Chapter shall not apply under its domestic non-Convention law.

2. - A Contracting State may declare that under its domestic non-Convention law this Chapter shall not apply –

(a) in relation to security collateral agreements entered into by natural persons or persons falling within such other categories as may be specified in the declaration;

(b) in relation to intermediated securities which are not permitted to be traded on an exchange or regulated market;

(c) in relation to security collateral agreements which provide for secured obligations falling within such categories as may be specified in the declaration.

**CHAPTER VI – SPECIAL PROVISIONS WITH RESPECT TO  
TITLE TRANSFER COLLATERAL AGREEMENTS AND CLOSE-OUT NETTING**

*Article 28*

*[Scope and interpretation in Chapter VI]*

1. - This Chapter applies to:

(a) collateral arrangements under which a collateral provider delivers intermediated securities under a title transfer collateral agreement to a collateral taker under Article 5(2) or Article 5(3) in order to secure or otherwise cover the performance of any existing or future obligation of the collateral provider or a third person; and

(b) netting agreements.

2. - In this Chapter –

(a) "title transfer collateral agreement" means an agreement, including an agreement providing for the sale and repurchase of securities, between a collateral provider and a collateral taker providing (in whatever terms) for the transfer of title to intermediated securities by the collateral provider to the collateral taker for the purpose of securing or otherwise covering the performance of obligations in respect of eligible transactions by operation of a close-out netting provision;

(b) "close-out netting provision" means a provision of an agreement under which, on the occurrence of an enforcement event, whether through the operation of netting or set-off or otherwise, either or both of the following may occur:

(i) the respective obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value, or are terminated and replaced by an obligation to pay such an amount; or

(ii) an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party;

(c) "enforcement event" means, in relation to a title transfer collateral agreement, an event on the occurrence of which, under the terms of that title transfer collateral agreement, the collateral taker is entitled to operate a close-out netting provision;

(d) "collateral securities" means intermediated securities delivered under a title transfer collateral agreement;

(e) "equivalent collateral" means, in relation to collateral securities delivered to a collateral taker under a title transfer collateral agreement, securities of the same description;

(f) "netting agreement" means an agreement between two parties that provides for netting, under a close-out netting provision, of present or future payment or delivery obligations or entitlements arising under or in connection with one or more eligible transactions entered into under the netting agreement;

(g) "eligible transaction" means any financial agreement, contract or transaction, including any terms and conditions incorporated by reference in such financial agreement, contract or transaction, pursuant to which payment or delivery obligations are due to be performed at a certain time or within a certain period of time, including:

(i) any swap, future, spot, forward, option or other derivative transaction relating to (without limitation) interest rates, currencies, commodities, energy products, electricity, equities, weather, bonds and other debt instruments, precious metals, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial,

commercial or economic consequence, or economic or financial indices or measures of economic or financial risk or value, including bandwidth, freight, emissions allowances and inflation and other statistical measures;

(ii) sale and repurchase agreements relating to securities or commodities;

(iii) any swap, spot, forward, option, contract for differences or other derivative in respect of, or combination of, one or more of the agreements, contracts, or transactions referred to in clauses (i) and (ii) above; and

(iv) any agreement, contract or transaction designated as an eligible transaction for this purpose by the central bank or other appropriate governmental authority of a Contracting State.

#### Article 29

##### [Enforcement of title transfer collateral agreements]

1. - On the occurrence of an enforcement event, the collateral taker may operate a close-out netting provision under a title transfer collateral agreement or under a netting agreement to which that title transfer collateral agreement relates.

2. - A close-out netting provision may be operated under paragraph 1:

(a) subject to any contrary provision of the title transfer collateral agreement or of a related netting agreement, without any requirement that:

(i) prior notice of the intention to operate the close-out netting provision shall have been given;

(ii) the terms of the operation of the close-out netting provision or any related valuation of collateral securities previously delivered to the collateral taker under the title transfer collateral agreement be approved by any court, public officer or other person; or

(iii) the close-out netting provision be operated in any prescribed manner;

and

(b) notwithstanding the commencement or continuation of an insolvency proceeding in respect of the collateral provider or the collateral taker.

3. - This Article is without prejudice to any requirement of the domestic non-Convention law to the effect that the valuation of collateral securities or the calculation of any obligations must be conducted in a commercially reasonable manner.

#### Article 30

##### [Recognition of title transfer collateral agreements]

1. - The law of a Contracting State shall permit a title transfer collateral agreement to take effect in accordance with its terms.

2. - If an enforcement event occurs while any obligation of the collateral taker to transfer equivalent collateral under a title transfer collateral agreement remains outstanding, the obligation may be the subject of a close-out netting provision.

#### Article 31

##### [Recognition of netting agreements and close-out netting provisions]

1. - The law of a Contracting State shall permit a netting agreement, including its close-out netting provision, to take effect in accordance with its terms, whether or not it relates to a security collateral agreement or a title transfer collateral agreement:



(a) notwithstanding the commencement or continuation of an insolvency proceeding in respect of either or both of the collateral provider and the collateral taker;

(b) notwithstanding any purported assignment, judicial or other attachment or other disposition of or in respect of the rights of either party under the netting agreement;

(c) without being subject to:

(i) any stay, moratorium or similar order, whether issued or granted by a court, administrative agency or insolvency administrator; or

(ii) any power of a court or an insolvency administrator to assume or repudiate individual agreements, contracts or transactions;

which would otherwise limit, delay or avoid the operation of the close-out netting provision under a netting agreement or prevent its taking effect in accordance with its terms.

2. - The law of a Contracting State shall permit a netting agreement, including its close-out netting provision, to take effect without being subject to any of the requirements mentioned in Article 29(2), unless otherwise agreed by the parties.

#### *Article 32*

##### *[Top-up or substitution of collateral]*

1. - Where a title transfer collateral agreement includes:

(a) an obligation to deliver collateral securities or additional collateral securities in order to take account of changes in the value of the collateral provided under the title transfer collateral agreement or in the amount of the secured obligations, in order to take account of any circumstances giving rise to an increase in the credit risk incurred by the collateral taker or in any other circumstances specified in the title transfer collateral agreement; or

(b) a right to withdraw collateral securities or other assets on providing collateral securities or other assets of substantially the same value,

the provision of securities or other assets as described in paragraph (a) and paragraph (b) shall not be treated as invalid, reversed or declared void solely on the basis that they are provided during a prescribed period before, or on the day of but before, the commencement of an insolvency proceeding in respect of the collateral provider, or after the obligations in respect of eligible transactions have been incurred.

#### *Article 33*

##### *[Declarations in respect of Chapter VI]*

1. - A Contracting State may declare that this Chapter shall not apply under its domestic non-Convention law.

2. - A Contracting State may declare that under its domestic non-Convention law this Chapter shall not apply –

(a) in relation to netting agreements or title transfer collateral agreements entered into by natural persons or persons falling within such other categories as may be specified in the declaration;

(b) in relation to intermediated securities which are not permitted to be traded on an exchange or regulated market;

(c) in relation to title transfer collateral agreements which provide for obligations in respect of eligible transactions falling within such categories as may be specified in the declaration.