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Professor Herbert Kronke
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Per e-mail

Dear Professor Kronke

New Triennial Work Programme

Thank you for your letter of 11 February 2008 regarding the new Triennial Work Programme 2009-2011. We are pleased to be invited to comment on capital markets aspects of the new Triennial Work Programme. As you know, we are a strong supporter of the work that UNIDROIT is currently doing in relation to intermediated securities. We have always believed that UNIDROIT is in a position to play a very important role in strengthening legal certainty in the cross-border financial markets, just as it does in strengthening legal certainty for international commerce through promotion of private law unification in other areas.

Accordingly, we would like to endorse the idea, mentioned in your letter, of developing a Convention on Netting in Financial Services. As you know, close-out netting is the process by which mutual obligations between financial market counterparties are reduced to a single net balance following a default by one of the parties. Payment netting is the process by which amounts due in the same currency on the same day between financial market counterparties are reduced to a single net balance for settlement purposes. Each form of netting has a crucial role to play in reducing risk in financial systems, the former in reducing credit risk arising upon a default and the latter in reducing settlement risk, which can be substantial given the high volumes of payments flowing through the financial markets each day.

The importance of netting, and in particular close-out netting, to efficiency, reduction of credit risk and therefore reduction of systemic risk in financial systems has been acknowledged by various national and international bodies, including the Bank for International Settlements, in numerous documents over the years. The leading banking supervisors have recognised the risk-reducing effect of close-out netting by permitting the allocation of regulatory capital against net rather than gross credit exposures, provided that

certain conditions are met (including the obtaining of robust legal comfort in all jurisdictions relevant to any close-out netting arrangement intended to benefit from this capital relief). Therefore in dealing with international banks, financial market participants in countries with robust legal regimes for close-out netting enjoy a clear competitive advantage over financial market participants in countries where such legal certainty is not available.

Over the past 20 years or so, more than 30 countries, including the world's leading developed jurisdictions and some emerging market jurisdictions, have adopted legislation to give effect to or strengthen netting and to ensure that it is enforceable against a local counterparty in the event of that counterparty's insolvency. A number of other countries are currently considering adopting netting legislation. A list of countries that have adopted netting legislation is on the ISDA website at http://www.isda.org/docproj/stat_of_net_leg.html. ISDA has been closely involved in most of these efforts, providing information and support to legislators, regulators and local financial market associations and market participants. ISDA's Model Netting Act (http://www.isda.org/docproj/model_netting.html), first published in 1996 and most recently revised in 2007, has been used as a model for the legislation in a number of countries.

This work, however, has necessarily proceeded piecemeal, and many different approaches have been taken. Not all of this legislation is of the same quality and there is considerable variation in the scope, core principles and degree of certainty of the legislation in different countries. There are a number of reasons for these variations, but they were largely driven by extraneous political, economic and historical factors at the time the legislation was adopted (some of the earliest such legislation is now nearly 20 years old). In other words, there is no conceptual obstacle to the development of a common international set of legal rules for netting in financial markets.

The development of an international instrument, ideally a Convention, to set out core rules for netting and to deal with some closely related issues (such as the inadvertent effect of anti-gambling laws, restrictions on legal capacity and the unintended application of insurance laws on legitimate financial market transactions), would:

- Potentially increase the number of countries where netting is enforceable, thereby further reducing systemic risk for financial markets involving participants from those countries
- Enhance legal certainty for cross-border financial transactions by creating a common set of international norms for netting
- Extend the benefits of netting to emerging market jurisdictions seeking to develop and strengthen their financial market infrastructure as part of broader economic development programmes
- Help to create a level playing field in the cross-border financial markets, increasing the ability of emerging market firms to compete for business in the international financial markets
- Improve the efficiency of the financial markets and therefore improve the ability of small- and medium-sized enterprises to obtain cost-effective access to financial services in order to find their growth and manage associated financial risks

It should be remembered that the risk-reducing benefits of netting are not limited to derivatives markets but can be applied in virtually all sectors of the financial markets, including spot trading in foreign exchange, securities, energy, metals and other commodities, as well as in the context of securities and commodities lending and repurchase (repo) transactions.

Finally, you invited us not only to express our views on the idea of a Netting Convention but also to comment on the relationship among and the priority to be given to each of the items listed in your letter in relation to the capital-markets agenda of UNIDROIT. You will perhaps not be surprised that we consider that, beyond, of course, finalising the proposed Securities Convention, developing a Netting Convention should be given top priority. While an Emerging Markets Guide could also be valuable, it is difficult to comment on this without knowing in more detail what it is intended to cover, although it is clear that there is a demand in the emerging markets for advice and assistance in relation to the development and strengthening of their local financial markets. The other proposed capital markets projects dealing with rights of foreign shareholders and corporate action processing, while no doubt important, are not central to ISDA's own mission, so we do not comment further on those.

The Netting Convention has the clear advantage over any proposed Guide of being a practical and targeted measure that is amply justified by existing empirical studies (including those by the Bank for International Settlements, as already mentioned) supporting the benefits of close-out netting, and as attested to by the number of countries that have already adopted netting legislation.

ISDA, together with the European Financial Markets Lawyers Group, is currently urging the European Commission to propose a European instrument on netting, to promote convergence of existing legal regimes for netting and to provide a common and sufficient basis for netting in the Member States that have most recently acceded to the EU as well as those likely to accede in the next few years. We are not certain at this point whether, despite the strong support of industry for such a measure, whether this is likely to proceed in the European context. If it does, there would clearly be a benefit in co-ordinating any European efforts with any UNIDROIT project. From ISDA's point of view as an international trade association, it is important that any such efforts are not confined to Europe but have the potential to benefit local financial markets all around the world. For this reason, we would clearly strongly support UNIDROIT taking up this project.

We would be pleased to continue our longstanding co-operation with UNIDROIT in relation to financial markets matters by working with you on this proposal. As you study the different items and any additional items that may be proposed for the next Triennial Work Programme, we would be happy to answer, if we can, any questions you might have about the ideal scope and/or content of a Netting Convention.

Yours sincerely,

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