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BY EMAIL

Division 4, Financial Services Branch
Financial Services and the Treasury Bureau
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Dear Sirs,

Consultation Paper on the Review of Corporate Rescue Procedure

The International Swaps and Derivatives Association, Inc. ("ISDA") is pleased to submit this comment letter in response to the Consultation Paper on the Review of Corporate Rescue Procedure (the "Consultation Paper") published by the Financial Services and the Treasury Bureau ("FSTB") in October 2009.

ISDA is an international organisation whose membership comprises over 840 member institutions from 58 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 ("OTC") derivatives to manage efficiently the financial market risks inherent in their core economic activities. As such, we believe that ISDA brings a unique and broad perspective, both in terms of the depth of representation across the derivatives industry and in terms of international representation and understanding of the regulatory arrangements in other jurisdictions.

1. Introduction

First and foremost, ISDA welcomes the policy objectives of the Hong Kong government in introducing a corporate rescue procedure which gives companies in financial difficulty the opportunity to try to survive as a going concern. In particular, ISDA is strongly supportive of the policy objectives of the provisions in the Companies (Corporate Rescue) Bill 2001 (the "2001 Bill") which exempt certain derivative contracts from the moratorium contained in the 2001 Bill. A party to a derivative contract in respect of whom a provisional supervisor has been appointed may well be in default under its derivative contract, either because the commencement of the

moratorium is treated as an insolvency event of default under the derivative contract or otherwise. ISDA acknowledges and agrees that the overriding policy concern supporting the different treatment of derivative contracts from other commercial transactions is the need to minimize systemic risk potentially arising from the insolvency or other default of a party to such contracts.

It is widely thought that systemic risk could be unacceptably high if market participants are unable to exercise contractual self-help remedies immediately upon the insolvency or other default of a counterparty to OTC derivative contracts. Such self-help remedies include the right to terminate, or close-out, all outstanding derivative contracts with the insolvent counterparty, net all payment obligations thereunder and foreclose on any collateral. Many OTC derivative transactions are entered into pursuant to a master agreement or other documentation, which provides for such self-help remedies. Following the termination of outstanding derivative transactions, the close-out amount, representing the lost value to one of the parties for terminating the transactions prior to their stated maturity, is calculated for each individual transaction. Such amounts are then netted against one another, so that a single net amount will be owed from one party to another. Netting arrangements, if enforceable, dramatically reduce the credit risks inherent in OTC derivative transactions, decreasing the risk that the insolvency of an institution could have systemic effects. Therefore, the importance of clarifying the enforceability of netting arrangements for OTC derivatives in the event of an insolvency cannot be overstated.

Derivatives contract values change over time and in response to changing market circumstances. Likewise, the market value of assets used as collateral are subject to volatility that may vary at different rates and in different directions from transaction values. If a solvent party cannot terminate its contract with an insolvent counterparty and simultaneously liquidate its collateral, the value of the contract and collateral may change substantially over the course of the insolvency proceeding, until the insolvent counterparty and the court decide the contract's fate. In the interim, the solvent party may replace or hedge the contract in its portfolio without knowing the economic impact of the court's decision will have on its portfolio. This is very different of course from a loan or similar debt obligation where the ultimate value at risk is known and certain, however uncertain the repayment. Without the derivatives contract exemption, this valuation and timing uncertainty would make substantial derivatives exposure untenable for a prudent party. Consistency, predictability and enhanced protection in the case of insolvency are extremely important in the derivatives market. Any uncertainty could lead institutions to withhold payments, which could also lead to reduced liquidity, impair the capital markets and lead to greater chance that a limited crisis will spread to other institutions and markets. Indeed, in the Legislative Council Brief to the 2001 Bill, it was noted that "to impose a moratorium on such contracts could involve unravelling innumerable other contracts which would cause chaos in the market concerned".

Although ISDA is pleased that the 2001 Bill makes progress towards clarifying and enhancing the validity of close-out, termination and netting provisions, ISDA is concerned that the proposals outlined in Section 11 of the 2001 Bill together with the list of contracts in Schedule 5 of the 2001 Bill may not be sufficiently comprehensive to prevent the very systemic risk which the 2001 Bill is trying to avoid. In particular, ISDA members are concerned that:

- The list of derivative contracts in Schedule 5 may not be representative of the derivative contracts which are currently available in the market and should be expanded.

- This list should be prospective and take into account future developments in the derivatives market.

- The exception which deals with set off in respect of master agreements should be further clarified.

- It is not clear whether cross-product set-off is permitted.

- Set-off should be allowed in respect of "title transfer" collateral arrangements.

- Exception to the moratorium should also be made to security and other collateral arrangements entered into in respect of derivative transactions.

- The exception to the moratorium which deals with guarantees should be clarified.

ISDA discussed the above issues in detail in a submission to the Bills Committee on the Companies (Corporate Rescue) Bill of the Legislative Council with a copy to FSTB on 6 February 2002 (the "2002 Submission"). Since the 2002 Submission, there have been some significant developments in relation to the OTC derivatives market and the ISDA documentation. Further, the list of the financial contracts exempted from the automatic stay contained in the United States Bankruptcy Code (the "US Code") [1] discussed in the 2002 Submission was expanded in 2005 and 2006 to further improve and clarify the netting process. As a result, we feel that it is necessary for us to re-examine the issues and highlight the latest developments in a new submission.

2. List of derivative transactions in Schedule 5

2.1 List of derivative contracts not representative of the market

The 2001 Bill provides that upon the appointment of the provisional supervisor, a proposed initial moratorium period of 45 days would apply that prohibits most creditors from enforcing their rights or taking actions (including any winding-up, exercise of set-off rights or enforcement of security) against the company. It is proposed that the moratorium period could be extended up to six months if approved by a meeting of creditors. Section 11(3) provides that contracts listed in Schedule 5 are, however, exempt from the application of this moratorium. Thus, the counterparty to a Schedule 5 derivative contract should be able to exercise contractual self-help including netting. ISDA supports the efforts of the draftsman of the 2001 Bill to provide, in Schedule 5, a comprehensive and flexible list of significant derivative transactions which reflects market practice. However, if this list approach is to be followed, ISDA believes that the list of derivative transactions in Schedule 5 of the Bill is not representative of all significant derivatives activities in the market. For example, this list does not include credit derivatives and bond option transactions and should include a wider range of commodity derivatives and a more comprehensive list of equity derivative transactions.

We believe that it is very important to define the scope of exempted transactions in a way that both provides the greatest amount of legal certainty as to scope but also is capable of accommodating continuing development and innovation in the financial markets. In the following sections, we will discuss how these exempted derivative transactions are defined under the ISDA Model Netting Act, the 2002 ISDA Master Agreement and the US Code. We believe

[1] 11 U.S.C. § 101 et seq. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which was signed into law in April, 2005 (the "2005 Act"), amended the US Code and related statutes as of October 17, 2005. The Financial Netting Improvements Act of 2006, which was signed into law on December 12, 2006 (the "2006 Act"), builds on the 2005 Act to further improve and clarify the netting process for certain financial contracts through amendments to the US Code and related statutes. References in this paper to the US Code will be references to such laws as amended by the 2005 Act and/or the 2006 Act.

that these examples can be used as a model to expand the list of derivative transactions in Schedule 5 of the 2001 Bill.

ISDA 2006 Model Netting Act

To date, ISDA has published three versions of Model Netting Act which is a model law intended to set out, by example, the basic principles necessary to ensure the enforceability of bilateral close-out netting as well as the enforceability of related financial collateral arrangements.[2] The ISDA Model Netting Acts have both been used successfully as models for netting legislation in a number of jurisdictions and as a guide for policy-makers and educators to the basic principles that should underlie a comprehensive statutory regime for close-out netting.

Section 1 of the 2006 MNA provides a definition of "qualified financial contract" which lists the various types of financial transaction that should ideally be covered. It also includes broad wording at the end of the definition intended to capture all types of financial transaction of a comparable nature in a way that is flexible enough to accommodate the development of new products. This avoids the need to introduce amending legislation periodically in order to keep pace with the markets, as has happened in a number of countries that introduce early netting statutes that were relatively restricted in scope.

We attach to this paper the text of the 2006 MNA and the Memorandum on the Implementation of Netting Legislation in Appendix A for your reference.

The United States Bankruptcy Code

Under the US Code, cases may be commenced either voluntarily by the debtor, or involuntarily by the debtor's creditors. As a general rule, the US Code offers two types of insolvency proceedings, one under Chapter 7 (liquidation) and one under Chapter 11 (reorganization). We understand that the corporate rescue procedure proposed under the 2001 Bill is comparable to the reorganization proceeding under Chapter 11 of the US Code, although the Hong Kong regime relies less on courts.

Section 362(a) of the US Code imposes the automatic stay at the moment a bankruptcy petition is filed. The automatic stay provides a period of time in which all judgments, collection activities, foreclosures, and repossessions of property are suspended and may not be pursued by the creditors on any debt or claim that arose before the filing of the bankruptcy petition.

Section 362(b)(17) of the US Code creates an exception to the scope of the automatic stay set forth in Section 362(a) of the US Code. This exception permits a swap participant or a financial participant to exercise any contractual rights under any security agreement or arrangement or other credit enhancement forming a part of or related to any swap agreement or exercise any contractual right to offset or net out any termination value, payment amount or other transfer obligation arising under or in connection with one or more such agreements, including any master agreement for such agreements. This permits netting of payment (or other property transfer) obligations at any time, including obligations arising after the filing of the bankruptcy petition. This provision also allows parties holding collateral or margin, or entitled to the benefits of a guarantee, to utilize such credit support, notwithstanding the bankruptcy filing.

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[2] The three documents were published in 1996, 2002 and 2006 respectively. References in this paper to the Model Netting Act will be references to the one published in 2006 (the “2006 MNA”).

Section 560 of the US Code preserves the contractual right of a swap participant or financial participant to liquidate, terminate or accelerate one or more "swap agreement[s]" and offset or net out any termination or payment amounts owed under it based solely upon the insolvent party's bankruptcy filing.

Together, the protected rights under Section 362(b)(17) and Section 560 allow the solvent party to terminate the master agreement, net the value of terminated transactions, setoff mutual debts and claims, and exercise its remedies to foreclose against collateral. The solvent party's unsecured claim (after netting, set off and application of collateral) will be treated the same as other, non-swap unsecured claims and will be paid only at the same time as other, non-swap unsecured claims as determined by a bankruptcy court.

The definitions of "swap participant", "financial participant" and "swap agreement" in the US Code are set out for ease of reference in Appendix B. It is to be noted that the range of derivative contracts covered in the definition is much broader than that covered in the 2001 Bill.

Other safe-harbored transactions under the US Code include securities contracts, forward contracts, commodity contracts and repurchase agreements. The definitions of "securities contract", "forward contract", "commodity contract" and "repurchase agreement" are also set out for ease of reference in Appendix B.

The benefits provided by the swap safe harbor provisions are invaluable. The Office of the Comptroller of the Currency at the US Treasury calculates netting benefits as the percentage difference between gross positive exposures and gross negative exposures for US banks. As of September 30, 2009, US banks reported gross positive exposures of $4.7 trillion and netted exposures of $485 billion. In essence, 90% of the risk in derivative transactions has been eliminated through the benefits of netting. We estimate very roughly that US banks alone would need to raise $100 billion of new capital to support this additional exposure if netting were to be eliminated.

Definition of Specified Transaction under the 2002 ISDA Master Agreement

ISDA suggests that the definition of "Specified Transaction" used in the 2002 ISDA Master Agreement (Multicurrency-Cross Border) can also be used as a model to expand the list of derivative transactions in Schedule 5. This definition is set out for ease of reference in Appendix C and clause (i) of this definition contains a list of derivative transactions.

The definition of Specified Transaction in the 2002 ISDA Master Agreement was formulated as the result of a review and analysis of certain provisions of the 1992 ISDA Master Agreements which ISDA began undertaking in late 1999. This process took into account the recommendations on documentation contained in the June 1999 report of the Counterparty Risk Management Policy Group entitled "Improving Counterparty Risk Management Practices" (the "CRMPG Report") and the experiences of ISDA's members (both dealers and end-users) since publication of the ISDA Master Agreements in 1992.

2.2 Is the Schedule 5 list of derivative contracts sufficiently prospective and does it take into account future developments in the derivatives market?

Paragraph 10 of Schedule 5 states that set-off is permitted in respect of a "derivative, combination or option in respect of, or agreement similar to, an agreement or contract referred to in any of items 1 to 9". ISDA welcomes the policy intention of this approach, which is designed to provide

flexibility so as to avoid the need to amend the definition as the nature and uses of derivatives transactions evolve.

However, ISDA believes that Paragraph 10 is not sufficiently clear-cut in its application and, for example, "or agreement similar to" may be construed more narrowly than intended. ISDA believes that the proposed definition should provide additional legal certainty by defining further this phrase, thus reducing legal risk.

In this respect, we note that section 1 of the 2006 MNA provides that "qualified financial contracts" include

"(x) any other agreement, contract or transaction similar to any agreement, contract or transaction referred to in paragraphs (a) to (w) with respect to one or more reference items or indices 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;

(y) any swap, forward, option, contract for differences or other derivative in respect of, or combination of, one or more agreements or contracts referred to in paragraphs (a) to (x)."

In addition to the use of generic language of the type reflected at the end of the definition of "qualified financial contract" in section 1 of the 2006 MNA, Part I section 2 of the 2006 MNA provides that the Central Bank of the relevant jurisdiction should be able to designate as "qualified financial contracts" any agreement or contract in addition to those already listed in the 2006 MNA. Where the Central Bank has this authority, it may use it in relation to a newly developed product, to enhance legal certainty in relation to that developing market. Such provisions would give more flexibility to the definition of the financial instrument to be covered by the netting legislation. However, local legislators should check whether this suggestion makes sense from a constitutional perspective under local law. If such an approach is not possible under the laws of Hong Kong, it is particularly important to make sure that the definition of financial instruments covers all types of instruments, currently existing or contemplated, which are supposed to be included in the netting legislation.

Again, ISDA believes the language set out in clause (ii) of the definition of Specified Transaction as set out in Appendix C can also be an appropriate model.

This refers to any transaction:

"which is a type of transaction that is similar to any transaction referred to in clause (i) that is currently, or in the future becomes, recurrently entered into in the financial markets (including terms and conditions incorporated by reference in such agreement) and which is a forward, swap, future, option or other derivative on one or more rates, currencies, commodities, equity securities or other equity instruments, debt securities or other debt instruments, or economic indices or measures of economic risk or value, or other benchmarks against which payments or deliveries are to be made (b) any combination of these transactions and……".

Thus, the list of Schedule 5 contracts firstly, will not be limited to those expressly named in Schedule 5 and, secondly, will be prospective, anticipating future developments in the derivatives market.

2.3 The exception to the moratorium which deals with set-off in respect of Master Agreements should be clarified

Paragraph 11 of Schedule 5 has the effect of allowing set-off in respect of master agreements for derivative transactions. ISDA welcomes this approach as protecting the right to net payment obligations across different categories of derivative contracts.

ISDA is of the view that it is not entirely clear whether, if parties were to use such master agreements to document non-derivative transactions, this would "taint" the right to set off in respect of derivative transactions which is preserved under the 2001 Bill. For example, assume a counterparty enters into a currency swap agreement, which is a Schedule 5 contract, and a weather derivative which is not. The ISDA Master Agreement provides that all transactions thereunder constitute "a single agreement". The question is whether this master agreement is a single protected currency swap agreement or a single potentially unprotected weather derivative agreement.

We note that section 4(i)(i) of the 2006 MNA expressly provides:

"a netting agreement shall be deemed to be a netting agreement notwithstanding the fact that such netting agreement may contain provisions relating to agreements, contracts or transactions that are not qualified financial contracts in terms of Part I section 1 of this Act, provided, however, that, for the purposes of this section, such netting agreement shall be deemed to be a netting agreement only with respect to those agreements, contracts or transactions that fall within the definition of "qualified financial contract" in Part I section 1 of this Act."

For the sake of clarity, ISDA proposes that whether a master agreement is a Schedule 5 contract should be "without regard to whether the master agreement provides for an agreement or contract which is not an agreement or contract referred to in any of items 1 to [10]". This will make it clear that a master agreement within Schedule 5 will be treated as such even if it documents transactions that are not within Schedule 5.

2.4 Is cross-product netting permitted?

Schedule 5 lists derivative transactions in respect of which netting is permitted but is silent in respect of cross-product netting. For example, say Party A and Party B have entered into, between them, (i) a basis swap which is in-the-money to the value of $10 to Party A; and (ii) a floor transaction which is in-the-money to the value of $10 to Party B. Both transactions are terminated on the same date. The parties have not entered into a derivatives master agreement. It is unclear whether, under the 2001 Bill as currently drafted, both Party A and Party B would have to pay $10 to each other following close-out or whether the parties can set off both sums resulting in no net flow of money.

We note that section 561 of the US Code expressly provides that cross-product netting is permitted. Sub-section (a) provides:

"(a) Subject to subsection (b), the exercise of any contractual right, because of a condition of the kind specified in section 365(e)(1), to cause the termination, liquidation, or acceleration of or to offset or net termination values, payment amounts, or other transfer obligations arising under or in connection with one or more (or the termination, liquidation, or acceleration of one or more)—

(1) securities contracts, as defined in section 741(7);

(2) commodity contracts, as defined in section 761(4);

(3) forward contracts;

(4) repurchase agreements;

(5) swap agreements; or

(6) master netting agreements,

shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by any order of a court or administrative agency in any proceeding under this title."

2.5 Collateral

As previously mentioned, the parties to OTC derivative transactions often build in risk reduction techniques such as close-out and netting provisions. Collateralisation is another means of mitigating risk. There are two principal forms of collateral arrangement used in the OTC derivatives market; one based on the creation of a security interest (which will be discussed more fully below); the other based on title transfer.

Title Transfer

Under title transfer, the collateral giver transfers full title in securities and/or cash to the taker and grants the taker the right to set off on default of the collateral giver, the taker's net exposure to the collateral giver under the derivative transaction against the value of the transferred securities and/or cash. Under this approach, the collateral taker owns the collateral, without restriction, and the collateral giver, if it performs in full, is only entitled to the return of securities and/or repayment of cash in the same currency.

For example, take a derivative transaction between Party A and Party B, both of which are Hong Kong corporates. Party A gives collateral of $10 to Party B using the title transfer approach. Party A is put under a moratorium and an insolvency event of default thus occurs under the derivative transaction which allows Party B to close out the derivative transaction. If the derivative transaction is in-the-money to the value of $6 to Party A, the derivative contract will allow Party B to net this against the value of the collateral. Thus, Party B will only have an obligation to return $4 to Party A.

Credit enhancement by title transfer is an intrinsic part of the arrangements between the parties and a means of reducing credit risk. There is an argument that set-off in respect of such arrangements and derivative transactions between the parties is already permitted under the present drafting of the 2001 Bill. Paragraph 11 of Schedule 5 contemplates that set-off under master agreements between the parties is permitted. Title transfer arrangements are usually part of such a master agreement. However, as this conclusion is not beyond doubt, ISDA is of the view that set-off arising out of title transfer arrangements should be expressly permitted as part of Schedule 5.

Security interest

Derivative contracts are often collateralised to reduce exposure. Foreclosing on collateral is a self-help remedy as intrinsic to a derivative transaction as close-out and netting. The ability of a market participant to enforce a security interest to satisfy a claim against an insolvent counterparty

without delay is important not only to reduce credit risk, but also to maintain liquidity in the securities markets and prevent systemic risk. A stay against the liquidation of securities can result in uncertainty and the potential inability of a party to finance the securities it has purchased or that have been pledged to it, which could result in gridlock and a chain of insolvencies.

ISDA is of the view that the present drafting leaves room for uncertainty as to whether the protection for set-off rights in respect of Schedule 5 derivative contracts extends to the exercise of rights under related security arrangements. Indeed, during a moratorium, section 11(2)(d) of the 2001 Bill provides that no steps may be taken to enforce any security interest over the company's property. This seems to be out-of-step with the position in Canada and in the United States.

In Canada, the Bankruptcy and Insolvency Act (Canada) (which we understand, Schedule 5 is based on) allows secured creditors to enforce their security held against the debtor (which is subject to the stay) in accordance with any applicable security agreement and pursuant to relevant security legislation.

The definition of “qualified financial contract” in the 2006 MNA includes a “collateral arrangement” which is defined to mean, among others, “a pledge or any other form of security interest in collateral, whether possessory or non possessory” (see Appendix A).

The definition of “swap agreement” in the US Code also expressly includes "any security agreement or arrangement or other credit enhancement related to any agreements or transactions referred to in clause (i) through (v), including any guarantee or reimbursement obligation by or to a swap participant or financial participant in connection with any agreement or transaction referred to in any such clause…....”(see Appendix B).

To address this concern, ISDA believes that a carve-out should be made in the 2001 Bill to the prohibition of set-off during a moratorium to allow enforcement of security interests in respect of Schedule 5 derivative transactions.

Guarantees

Paragraph 12 of Schedule 5 allows set-off under guarantees for the listed derivative transactions and master agreements in respect thereof. As a guarantee, along with collateral and netting provisions, are part of the credit support structure of the parties to a derivative contract, ISDA welcomes such provisions. However, similar points can be made in respect of this Paragraph 12 of Schedule 5 as are set out in the section headed "Master Agreement" above. That is, it is unclear whether set-off in respect of a guarantee is permitted if the guarantee guarantees Schedule 5 contracts as well as non-Schedule 5 contracts.

2.6 Clarification requested

ISDA would be grateful if the FSTB would provide clarification of the following: Paragraph 9 of Schedule 5 refers to an agreement "to clear or settle securities transactions or futures contracts or to act as depository for securities". It is currently not clear what such agreements are and further clarification of the intention of this language would be welcome.

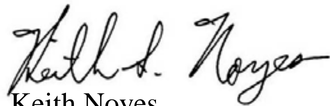
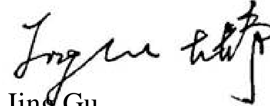
3. Conclusion

ISDA fully supports the objectives of the 2001 Bill in introducing a moratorium period in which companies in financial difficulty are given protection from creditors' actions. However, ISDA believes that it is important that any amendments to existing legislation reflect current market

practice related to the derivatives market and provide sufficient flexibility for future developments. ISDA strongly believes that the provisions in this bill represent a valuable opportunity to take tangible steps to mitigate systemic risk and improve the integrity of the financial system.

ISDA is grateful for the opportunity to comment on the Consultation Paper and would be pleased to discuss the issues addressed above in further detail or otherwise assist in any way that the FSTB deems appropriate.

Yours sincerely,

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International Swaps and Derivatives Association, Inc.

Appendix A

1. 2006 Model Netting Act

2. Memorandum on the Implementation on Netting Legislation

Appendix B

Swap Agreement

U.S.C. §101 (22A)

The term “financial participant” means

(A) an entity that, at the time it enters into a securities contract, commodity contract, swap agreement, repurchase agreement, or forward contract, or at the time of the date of the filing of the petition, has one or more agreements or transactions described in paragraph (1), (2), (3), (4), (5), or (6) of section 561 (a) with the debtor or any other entity (other than an affiliate) of a total gross dollar value of not less than $1,000,000,000 in notional or actual principal amount outstanding (aggregated across counterparties) at such time or on any day during the 15-month period preceding the date of the filing of the petition, or has gross mark-to-market positions of not less than $100,000,000 (aggregated across counterparties) in one or more such agreements or transactions with the debtor or any other entity (other than an affiliate) at such time or on any day during the 15-month period preceding the date of the filing of the petition; or

(B) a clearing organization (as defined in section 402 of the Federal Deposit Insurance Corporation Improvement Act of 1991).

(53B) The term "swap agreement"—

(A) means—

(i) any agreement, including the terms and conditions incorporated by reference in such agreement, which is—

(I) an interest rate swap, option, future, or forward agreement, including a rate floor, rate cap, rate collar, cross-currency rate swap, and basis swap;

(II) a spot, same day-tomorrow, tomorrow-next, forward, or other foreign exchange, precious metals, or other commodity agreement;

(III) a currency swap, option, future, or forward agreement;

(IV) an equity index or equity swap, option, future, or forward agreement;

(V) a debt index or debt swap, option, future, or forward agreement;

(VI) a total return, credit spread or credit swap, option, future, or forward agreement;

(VII) a commodity index or a commodity swap, option, future, or forward agreement;

(VIII) a weather swap, option, future, or forward agreement;

(IX) an emissions swap, option, future, or forward agreement; or

(X) an inflation swap, option, future, or forward agreement;

(ii) any agreement or transaction that is similar to any other agreement or transaction referred to in this paragraph and that—

(I) is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap or other derivatives markets (including terms and conditions incorporated by reference therein); and

(II) is a forward, swap, future, option, or spot transaction on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, 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;

(iii) any combination of agreements or transactions referred to in this subparagraph;

(iv) any option to enter into an agreement or transaction referred to in this subparagraph;

(v) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), (iii), or (iv), together with all supplements to any such master agreement, and without regard to whether the master agreement contains an agreement or transaction that is not a swap agreement under this paragraph, except that the master agreement shall be considered to be a swap agreement under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in clause (i), (ii), (iii), or (iv); or

(vi) any security agreement or arrangement or other credit enhancement related to any agreements or transactions referred to in clause (i) through (v), including any guarantee or reimbursement obligation by or to a swap participant or financial participant in connection with any agreement or transaction referred to in any such clause, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with Section 562;

(B) is applicable for purposes of this title only, and shall not be construed or applied so as to challenge or affect the characterization, definition, or treatment of any swap agreement under any other statute, regulation, or rule, including the Gramm-Leach-Bliley Act, the Legal Certainty for Bank Products Act of 2000, the securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934) and the Commodity Exchange Act.

(53C) The term "swap participant" means an entity that, at any time before the filing of the petition, has an outstanding swap agreement with the debtor.

§362 also exempts from the mandatory stay commodity contracts, forward contracts, securities contracts and repurchase contracts. For completeness, the definitions of such terms are set out below:

<u>Commodity contract</u>

U.S.C. §761(4)

"commodity contract" means—

(A) with respect to a futures commission merchant, contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade;

(B) with respect to a foreign futures commission merchant, foreign future;

(C) with respect to a leverage transaction merchant, leverage transaction;

(D) with respect to a clearing organization, contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization, or commodity option traded on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization;

(E) with respect to a commodity options dealer, commodity option;

(F) any other agreement or transaction that is similar to an agreement or transaction referred to in this paragraph;

(G) any combination of the agreements or transactions referred to in this paragraph;

(H) any option to enter into an agreement or transaction referred to in this paragraph;

(I) a master agreement that provides for an agreement or transaction referred to in subparagraph (A), (B), (C), (D), (E), (F), (G), or (H), together with all supplements to such master agreement, without regard to whether the master agreement provides for an agreement or transaction that is not a commodity contract under this paragraph, except that the master agreement shall be considered to be a commodity contract under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in subparagraph (A), (B), (C), (D), (E), (F), (G), or (H); or

(J) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this paragraph, including any guarantee or reimbursement obligation by or to a commodity broker or financial participant in connection with any agreement or transaction referred to in this paragraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562;

Forward contract

U.S.C. §101(25)

"Forward contract" means

(A) a contract (other than a commodity contract, as defined in section 761) for the purchase, sale or transfer of a commodity, as defined in section 761(8) of this title, or any similar good, article, service, right or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into, including, but not limited to, a repurchase or reverse repurchase transaction (whether or not such repurchase or reverse repurchase transaction is a 'repurchase agreement', as defined in this section) consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any similar agreement;

(B) any combination of agreements or transactions referred to in subparagraphs (A) and (C);

(C) any option to enter into an agreement or transaction referred to in subparagraph (A) or (B);

(D)a master agreement that provides for an agreement or transaction referred to in subparagraph (A), (B) or (C), together with all supplements to any such master agreement, without regard to whether such master agreement provides for an agreement or transaction that is not a forward contract under this paragraph, except that such master agreement shall be considered to be a forward contract under this paragraph only with respect to each agreement or transaction under such master agreement that is referred to in subparagraph (A), (B) or (C); or

(E) any security agreement or arrangement, or other credit enhancement related to any agreement or transaction referred to in subparagraph (A), (B), (C) or (D), including any guarantee or reimbursement obligation by or to a forward contract merchant or financial participant in connection with any agreement or transaction referred to in any such subparagraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562."

Securities contract

U.S.C. § 741(7)

"Securities contract"—

(A) means—:

"(i) a contract for the purchase, sale, or loan of a security [(as defined in 11 U.S.C. 101(49))], a certificate of deposit, a mortgage loan, any interest in a mortgage loan, a group or index of securities, certificates of deposit, or mortgage loans or interests therein (including an interest therein or based on the value thereof), or option on any of the foregoing, including any option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option, and including any repurchase or reverse repurchase transaction on any such security, certificate of deposit, mortgage loan, interest, group or index, or option (whether or not such repurchase or reverse repurchase transaction is a "repurchase agreement" as defined in Section 101);

(ii) any option entered into on a national securities exchange relating to foreign currencies;

(iii) the guarantee (including by novation) by or to any securities clearing agency of a settlement of cash, securities, certificates of deposit, mortgage loans or interests therein, group or index of securities, or mortgage loans or interests therein (including any interest therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option (whether or not such settlement is in connection with any agreement or transaction referred to in clauses (i) through (xi));

(iv) any margin loan;

(v) any extension of credit for the clearance or settlement of securities transactions;

(vi) any loan transaction coupled with a securities collar transaction, any prepaid forward securities transaction, or any total return swap transaction coupled with a securities sale transaction;

(vii) any other agreement or transaction that is similar to an agreement or transaction referred to in this subparagraph;

(viii) any combination of the agreements or transactions referred to in this subparagraph;

(ix) any option to enter into any agreement or transaction referred to in this subparagraph;

(x) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), (iii), (iv), (v), (vi), (vii), (viii), or (ix), together with all supplements to any such master agreement, without regard to whether the master agreement provides for an agreement or transaction that is not a securities contract under this subparagraph, except that such master agreement shall be considered to be a securities contract under this subparagraph only with respect to each agreement or transaction under such master agreement that is referred to in clause (i), (ii), (iii), (iv), (v), (vi), (vii), (viii), or (ix); or

(xi) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this subparagraph, including any guarantee or reimbursement obligation by or to a stockbroker, securities clearing agency, financial institution, or financial participant in connection with any agreement or transaction referred to in this subparagraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with Section 562; and

(B) does not include any purchase, sale, or repurchase obligation under a participation in a commercial mortgage loan;

Repurchase agreement

U.S.C. §101(47)

The term "repurchase agreement" (which definition also applies to a reverse repurchase agreement)—

(A) means—

(i) an agreement, including related terms, which provides for the transfer of one or more certificates of deposit, mortgage related securities (as defined in section 3 of the Securities Exchange Act of 1934), mortgage loans, interests in mortgage related securities or mortgage loans, eligible bankers' acceptances, qualified foreign government securities (defined as a security that is a direct obligation of, or that is fully guaranteed by, the central government of a member of the Organization for Economic Cooperation and Development), or securities that are direct obligations of, or that are fully guaranteed by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers' acceptances, securities, mortgage loans, or interests, with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers' acceptance, securities, mortgage loans, or interests of the kind described in this clause, at a date certain not later than 1 year after such transfer or on demand, against the transfer of funds;

(ii) any combination of agreements or transactions referred to in clauses (i) and (iii);

(iii) an option to enter into an agreement or transaction referred to in clause (i) or (ii);

(iv) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), or (iii), together with all supplements to any such master agreement, without regard to whether such master agreement provides for an agreement or transaction that is not a repurchase agreement under this paragraph, except that such master agreement shall be considered to be a repurchase agreement under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in clause (i), (ii), or (iii); or

(v) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in clause (i), (ii), (iii), or (iv), including any guarantee or reimbursement obligation by or to a repo participant or financial participant in connection with any agreement or transaction referred to in any such clause, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562 of this title; and

(B) does not include a repurchase obligation under a participation in a commercial mortgage loan.

Appendix C

Definition of Specified Transaction in the 2002 ISDA Master Agreement

"Specified Transaction" means, subject to the Schedule, (a) any transaction (including an agreement with respect to any such transaction) now existing or hereafter entered into between one party to this Agreement (or any Credit Support Provider of such party or any applicable Specified Entity of such party) and the other party to this Agreement (or any Credit Support Provider of such other party or any applicable Specified Entity of such other party) which is not a Transaction under this Agreement but (i) which is a rate swap transaction, swap option, basis swap, forward rate transaction, commodity swap, commodity option, equity or equity index swap, equity or equity index option, bond option, interest rate option, foreign exchange transaction, cap transaction, floor transaction, collar transaction, currency swap transaction, cross-currency rate swap transaction, currency option, credit protection transaction, credit swap, credit default swap, credit default option, total return swap, credit spread transaction, repurchase transaction, reverse repurchase transaction, buy/sell-back transaction, securities lending transaction, weather index transaction or forward purchase or sale of a security, commodity or other financial instrument or interest (including any option with respect to any of these transactions) or (ii) which is a type of transaction that is similar to any transaction referred to in clause (i) above that is currently, or in the future becomes, recurrently entered into in the financial markets (including terms and conditions incorporated by reference in such agreement) and which is a forward, swap, future, option or other derivative on one or more rates, currencies, commodities, equity securities or other equity instruments, debt securities or other debt instruments, economic indices or measures of economic risk or value, or other benchmarks against which payments or deliveries are to be made, (b) any combination of these transactions and (c) any other transaction identified as a Specified Transaction in this Agreement or the relevant confirmation.

2006 MODEL NETTING ACT[1]

Part I : Netting

1. **<u>Definitions</u>**

In this Act:

"Bank" means the Central Bank of [*insert applicable jurisdiction*];

"cash" means money credited to an account in any currency, or a similar claim for repayment of money, such as a money market deposit;

"collateral" means any of the following:

(i) cash in any currency;

(ii) securities of any kind, including (without limitation) debt and equity securities;

(iii) guarantees, letters of credit and obligations to reimburse; and

(iv) any asset commonly used as collateral in [*insert applicable jurisdiction*];

"collateral arrangement" means any margin, collateral or security arrangement or other credit enhancement related to or forming part of a netting agreement or one or more qualified financial contracts entered into thereunder, including (without limitation):

(i) a pledge or any other form of security interest in collateral, whether possessory or non possessory;

(ii) a title transfer collateral arrangement; and

(iii) any guarantee, letter of credit or reimbursement obligation by or to a party to one or more qualified financial contracts, in respect of those qualified financial contracts;

"insolvent party" is the party in relation to which an insolvency proceeding under the laws of [*insert applicable jurisdiction*] has been instituted;

"liquidator" means the liquidator, receiver, trustee, conservator or other person or entity which administers the affairs of an insolvent party during an insolvency proceeding under the laws of [*insert applicable jurisdiction*];

"netting" means the occurrence of any or all of the following:

(i) the termination, liquidation and/or acceleration of any payment or delivery obligations or entitlements under one or more qualified financial contracts entered into under a netting agreement;

(ii) the calculation or estimation of a close-out value, market value, liquidation value or replacement value in respect of each obligation or entitlement or group of obligations or entitlements terminated, liquidated and/or accelerated under (i);

[1] Version 2, incorporating minor revisions to version 1 published in March 2006.

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(iii) the conversion of any values calculated or estimated under (ii) into a single currency; and

(iv) the determination of the net balance of the values calculated under (ii), as converted under (iii), whether by operation of set-off or otherwise;

"netting agreement" means (i) any agreement between two parties that provides for netting of present or future payment or delivery obligations or entitlements arising under or in connection with one or more qualified financial contracts entered into under the agreement by the parties to the agreement (a "master netting agreement"), (ii) any master agreement between two parties that provides for netting of the amounts due under two or more master netting agreements (a "master-master netting agreement") and (iii) any collateral arrangement related to or forming part of one or more of the foregoing;

"non-insolvent party" is the party other than the insolvent party;

"party" means a person constituting one of the parties to a netting agreement;

"person" includes [individuals], [partnerships], [corporations], [regulated entities such as banks, insurance companies and broker-dealers], [or any other body corporate whether organized under the laws of [*insert applicable jurisdiction*] or under the laws of any other jurisdiction], [and any unit or political sub-division of central or regional government], [and any international or regional development bank or other international or regional organization];

"qualified financial contract" means any financial agreement, contract or transaction, including any terms and conditions incorporated by reference in any 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 and whether or not subject to any condition or contingency. Qualified financial contracts include (without limitation):

(a) a currency, cross-currency or interest rate swap;
(b) a basis swap;
(c) a spot, future, forward or other foreign exchange transaction;
(d) a cap, collar or floor transaction;
(e) a commodity swap;
(f) a forward rate agreement;
(g) a currency or interest rate future;
(h) a currency or interest rate option;
(i) an equity derivative, such as an equity or equity index swap, equity forward, equity option or equity index option;
(j) a derivative relating to bonds or other debt securities or to a bond or debt security index, such as a total return swap, index swap, forward, option or index option;
(k) a credit derivative, such as a credit default swap, credit default basket swap, total return swap or credit default option;
(l) an energy derivative, such as an electricity derivative, oil derivative, coal derivative or gas derivative;
(m) a weather derivative, such as a weather swap or weather option;
(n) a bandwidth derivative;
(o) a freight derivative;
(p) an emissions derivative, such as an emissions allowance or emissions reduction transaction;
(q) an economic statistics derivative, such as an inflation derivative;
(r) a property index derivative;
(s) a spot, future, forward or other securities or commodities transaction;
(t) a securities contract, including a margin loan and an agreement to buy, sell, borrow or lend securities, such as a securities repurchase or reverse repurchase agreement, a securities

lending agreement or a securities buy/sell-back agreement, including any such contract or agreement relating to mortgage loans, interests in mortgage loans or mortgage-related securities;

(u) a commodities contract, including an agreement to buy, sell, borrow or lend commodities, such as a commodities repurchase or reverse repurchase agreement, a commodities lending agreement or a commodities buy/sell-back agreement;

(v) a collateral arrangement;

(w) an agreement to clear or settle securities transactions or to act as a depository for securities;

(x) any other agreement, contract or transaction similar to any agreement, contract or transaction referred to in paragraphs (a) to (w) with respect to one or more reference items or indices 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 ;

(y) any swap, forward, option, contract for differences or other derivative in respect of, or combination of, one or more agreements or contracts referred to in paragraphs (a) to (x); and

(z) any agreement, contract or transaction designated as such by the Bank under this Act;

"title transfer collateral arrangement" means a margin, collateral or security arrangement related to a netting agreement based on the transfer of title to collateral, whether by outright sale or by way of security, including (without limitation) a sale and repurchase agreement, securities lending agreement, securities buy/sell-back agreement or an irregular pledge.

2. **Powers of the Bank.** The Bank may, by notice issued under this section, designate as "qualified financial contracts" any agreement, contract or transaction, or type of agreement, contract or transaction, in addition to those listed in this Act.

3. **Enforceability of a Qualified Financial Contract.** A qualified financial contract shall not be and shall be deemed never to have been void or unenforceable by reason of [*insert the applicable law*] relating to games, gaming, gambling, wagering or lotteries.

4. **Enforceability of a Netting Agreement.**

(a) General rule. The provisions of a netting agreement will be enforceable in accordance with their terms, including against an insolvent party, and, where applicable, against a guarantor or other person providing security for a party and will not be stayed, avoided or otherwise limited by

(i) any action of the liquidator,

(ii) any other provision of law relating to bankruptcy, reorganization, composition with creditors, receivership, conservatorship or any other insolvency proceeding an insolvent party may be subject to, or

(iii) any other provision of law that may be applicable to an insolvent party,

subject to the conditions contained in the applicable netting agreement.

(b) Limitation on obligation to make payment or delivery. After commencement of insolvency proceedings in relation to a party, the only obligation, if any, of either party to make payment or delivery under a netting agreement shall be equal to its net obligation to the other party as determined in accordance with the terms of the applicable netting agreement.

(c) Limitation on right to receive payment or delivery. After commencement of insolvency proceedings in relation to a party, the only right, if any, of either party to receive payment or delivery under a netting agreement shall be equal to its net entitlement with respect to the other party as determined in accordance with the terms of the applicable netting agreement.

(d) Limitation on powers of the liquidator. Any powers of the liquidator to assume or repudiate individual contracts or transactions will not prevent the termination, liquidation and/or acceleration of all payment or delivery obligations or entitlements under one or more qualified financial contracts entered into under or in connection with a netting agreement, and will apply, if at all, only to the net amount due in respect of all of such qualified financial contracts in accordance with the terms of such netting agreement;

(e) Limitation of insolvency laws prohibiting set-off. The provisions of a netting agreement which provide for the determination of a net balance of the close-out values, market values, liquidation values or replacement values calculated in respect of accelerated and/or terminated payment or delivery obligations or entitlements under one or more qualified financial contracts entered into thereunder will not be affected by any applicable insolvency laws limiting the exercise of rights to set off, offset or net out obligations, payment amounts or termination values owed between an insolvent party and another party.

(f) Preferences and fraudulent transfers. The liquidator of an insolvent party may not avoid:

(i) any transfer, substitution or exchange of cash, collateral or any other interests under or in connection with a netting agreement from the insolvent party to the non-insolvent party; or

(ii) any payment or delivery obligation incurred by the insolvent party and owing to the non-insolvent party under or in connection with a netting agreement

on the grounds of it constituting a [preference] [transfer during a suspect period] by the insolvent party to the non-insolvent party, unless there is clear and convincing evidence that the non-insolvent party (i) made such transfer or (ii) incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the insolvent party was indebted or became indebted, on or after the date (i) such transfer was made or (ii) such obligation was incurred.

(g) Preemption. No stay, injunction, avoidance, moratorium, or similar proceeding or order, whether issued or granted by a court, administrative agency, liquidator or otherwise, shall limit or delay application of otherwise enforceable netting agreements in accordance with subsections (a), (b) and (c) of this section of this Act.

(h) Realization and liquidation of collateral. Unless otherwise agreed by the parties, the realization, appropriation and/or liquidation of collateral under a collateral arrangement shall take effect or occur without any requirement that prior notice shall be given to, or consent be received from, any party, person or entity, provided that this subsection is without prejudice to any applicable provision of law requiring that the realization, appropriation and/or liquidation of collateral is conducted in a commercially reasonable manner.

(i) Scope of this provision.

(i) For the purposes of this section, a netting agreement shall be deemed to be a netting agreement notwithstanding the fact that such netting agreement may contain provisions relating to agreements, contracts or transactions that are not qualified financial contracts in terms of Part I section 1 of this Act, provided, however, that, for the purposes of this section, such netting agreement shall be deemed to be a netting agreement only with respect to those

agreements, contracts or transactions that fall within the definition of "qualified financial contract" in Part I section 1 of this Act.

(ii) For the purposes of this section, a collateral arrangement shall be deemed to be a collateral arrangement notwithstanding the fact that such collateral arrangement may contain provisions relating to agreements, contracts or transactions that are not a netting agreement or qualified financial contract entered into thereunder in terms of Part I section 1 of this Act, provided, however, that, for the purposes of this section, such collateral arrangement shall be deemed to be a collateral arrangement only with respect to those agreements, contracts or transactions that fall within the definition of "netting agreement" or "qualified financial contract" entered into thereunder in Part I section 1 of this Act.

(iii) For the purposes of this section, a netting agreement and all qualified financial contracts entered into thereunder shall constitute a single agreement.

(iv) For the purposes of this section, the term "netting agreement" shall include the term "multibranch netting agreement" (as defined in Part II of this Act), provided, however, that in a separate insolvency of a branch or agency of a foreign party (as defined in Part II of this Act) in [*insert applicable jurisdiction*] the enforceability of the provisions of the multibranch netting agreement shall be determined in accordance with Part II of this Act.

Part II : Multibranch Netting

1. **Additional Definitions**

In this Act:

"branch/agency net payment entitlement" means with respect to a multibranch netting agreement the amount, if any, that would have been owed by the non-insolvent party to the foreign party after netting only those qualified financial contracts entered into by the non-insolvent party with the branch or agency of the foreign party in [*insert applicable jurisdiction*] under such multibranch netting agreement.

"branch/agency net payment obligation" means with respect to a multibranch netting agreement the amount, if any, that would have been owed by the foreign party to the non-insolvent party after netting only those qualified financial contracts entered into by the non-insolvent party with the branch or agency of the foreign party in [*insert applicable jurisdiction*] under such multibranch netting agreement;

"foreign party" is a party whose home country is a country other than [*insert applicable jurisdiction*];

"global net payment entitlement" means the amount, if any, owed by the non-insolvent party (or that would be owed if the relevant multibranch netting agreement provided for payments to either party, upon termination of qualified financial contracts thereunder, under any and all circumstances) to the foreign party as a whole after giving effect to the netting provisions of a multibranch netting agreement with respect to all qualified financial contracts subject to netting under such multibranch netting agreement;

"global net payment obligation" means the amount, if any, owed by the foreign party as a whole to the non-insolvent party after giving effect to the netting provisions of a multibranch netting agreement with respect to all qualified financial contracts subject to netting under such multibranch netting agreement;

"home country" means the country where a party to a netting agreement is organized or incorporated;

"home office" means the home country office of a party to a netting agreement that is a bank;

"multibranch netting agreement" means a netting agreement between two parties under which at least one party enters into qualified financial contracts through – in addition to its home office – one or more of its branches or agencies located in countries other than its home country;

"party" means, for purposes of this Part II of this Act, a person constituting one of the parties to a multibranch netting agreement.

2. **Enforceability of a Multibranch Netting Agreement in an Insolvency of a Branch or Agency of a Foreign Party.**

(a) Limitation on the non-insolvent party's right to receive payment.

(i) The liability of an insolvent branch or agency of a foreign party or its liquidator in [*insert applicable jurisdiction*] under a multibranch netting agreement shall be calculated as of the date of the termination of the qualified financial contracts entered into under such multibranch netting agreement in accordance with its terms and shall be limited to the lesser of (i) the global net payment obligation and (ii) the branch/agency net payment obligation. The liability under this section of the insolvent branch or agency of the foreign party or its the liquidator shall be reduced by any amount otherwise paid to or received by the non-insolvent party in respect of the global net payment obligation pursuant to such multibranch netting agreement which if added to the liability of the liquidator under this section would exceed the global net payment obligation.

(ii) The liability of the liquidator of an insolvent branch or agency of a foreign party under a multibranch netting agreement to the non-insolvent party shall be reduced by the fair market value of, or the amount of any proceeds of, collateral that secures or supports the obligations of the foreign party under the multibranch netting agreement and has been applied to satisfy the obligations of the foreign party pursuant to the multibranch netting agreement to the non-insolvent party.

(b) Limitation on the foreign party's rights to receive payment based on payments made in accordance with insolvency proceedings relating to the foreign party in other jurisdictions. The liability of the non-insolvent party under this section shall be reduced by any amount otherwise paid to or received by the liquidator or any other liquidator or receiver of the foreign party in its home country or any other country in respect of the global net payment entitlement pursuant to such multibranch netting agreement which if added to the liability of the non-insolvent party under this section would exceed the global net payment entitlement. The liability of the non-insolvent party under this section to the liquidator pursuant to such multibranch netting agreement also shall be reduced by the fair market value of, or the amount of any proceeds of, collateral that secures or supports the obligations of the non-insolvent party and has been applied to satisfy the obligations of the non-insolvent party pursuant to such multibranch netting agreement to the foreign party.

3. **Limitation on the terms of the multibranch netting agreement relating to a collateral arrangement.** The non-insolvent party to a multibranch netting agreement which has a perfected security interest in collateral, or other valid title, lien or security interest in collateral enforceable against third parties pursuant to such multibranch netting agreement, may retain all such collateral and upon termination of such multibranch netting agreement in accordance with its terms apply such collateral in satisfaction of any claims secured by the collateral, provided that the total amount so applied to such claims shall in no event exceed the global net payment obligation, if any. Any excess collateral shall be returned to the foreign party.

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MEMORANDUM ON THE IMPLEMENTATION OF NETTING LEGISLATION

A Guide for Legislators and Other Policy-Makers

March 2006

The International Swaps and Derivatives Association, Inc. (**ISDA**) has recently published the 2006 Model Netting Act (the **2006 MNA**). The 2006 MNA is a model law intended to set out, by example, the basic principles necessary to ensure the enforceability of bilateral close-out netting, including bilateral close-out netting on a multibranch basis, as well as the enforceability of related financial collateral arrangements.[1]

The 2006 MNA is an updated version of our 2002 Model Netting Act, which was in turn an updated version of our 1996 Model Netting Act. The 1996 and 2002 Model Netting Acts have both been used successfully as models for netting legislation in a number of jurisdictions and as a guide for policy-makers and educators to the basic principles that should underlie a comprehensive statutory regime for close-out netting.

The 2002 Model Netting Act extended the coverage of the 1996 Model Netting Act, in various ways to reflect the evolution of the financial markets, including providing protection to financial collateral arrangements entered into in connection with a netting agreement. The 2006 MNA similarly updates and extends the 2002 MNA.

The purpose of this Memorandum is to provide practical advice and guidance to governmental officials and other policy-makers in countries that are currently considering implementing netting legislation. [2] In preparing this guidance, we have drawn on:

- Our experience over the past 20 years of dialogue with law-makers, regulators and other government officials in countries around the world, from a variety of legal traditions, seeking to implement netting legislation locally in order to strengthen and modernize their national financial markets and to ensure the competitiveness of their leading financial institutions and other professional financial market participants in the global marketplace

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1 In this Memorandum we refer to "netting law" or "netting legislation" and to "netting" or "close-out netting" for ease of reference. References to "netting law" or "netting legislation", are intended to encompass both the close-out netting and collateral aspects of the legislation.

2 ISDA gratefully acknowledges the assistance of the Paris, New York and London offices of Allen & Overy LLP in the preparation of this Memorandum.

- Our collection of detailed reasoned legal opinions, annually updated, on close-out netting under the ISDA Master Agreements from nearly fifty jurisdictions3

In preparing this Memorandum, we have had particular regard to the experience and concerns of civil law jurisdictions, although we intend the general principles discussed below to be of assistance to national authorities in jurisdictions representing all legal traditions. We recognize that in many countries it will not necessarily be feasible, as a matter of theory or practice, to implement the 2006 MNA substantially in the form in which we have published it. Equally, in preparing the 2006 MNA we have taken care to avoid using legal concepts that would be specific to a given legal culture (e.g., common law as opposed to civil law). The 2006 MNA is generic in the sense that its provisions are self-contained and generally do not rely on jurisdiction-specific concepts.

We are aware that actual netting legislation sharing the same purpose as the 2006 MNA will often need to be in a form which substantially differs from the generic form set out in the 2006 MNA. This may be for a variety of reasons, ranging from technical (e.g., taking into account existing local legal concepts or doctrines) to legal-cultural (e.g., the detailed style of drafting adopted in the 2006 MNA may be considered inappropriate in jurisdictions of the civil law tradition).

We demonstrate in this Memorandum how the 2006 MNA may, nonetheless, be used even in civil law jurisdictions as a starting point for the preparation of appropriate legislation. We also make certain methodological suggestions to facilitate the effective translation of the provisions of the 2006 MNA into a body of provisions that takes into account these various local requirements while achieving effectively the purposes of the 2006 MNA.

1. PRELIMINARY CONSIDERATIONS

1.1 The objectives of netting legislation

In summary, the primary purpose in adopting netting legislation should be to ensure the enforceability of close-out netting upon the occurrence of any termination event or event of default under the netting agreement, both prior to and following the commencement of insolvency proceedings, in each case in accordance with the terms of the parties' contract. This purpose can be achieved in a variety of ways. For instance, in a legal system where there only exist specific and well-identified issues which may conflict with the enforceability of close-out netting as described in the 2006 MNA, it would in theory be possible to adopt netting legislation with specific objectives of resolving these issues so that the overall purpose of enforceability of close-out netting would be achieved. While a benefit of this approach would be to achieve the desired result in a very economical way, the resulting local legislation may be very technical and hardly accessible to non-specialist lawyers.

Alternatively, legislators may chose to adopt an approach which goes beyond addressing the already identified issues and more generally confirms the effectiveness of close-out netting and the various intermediate steps. This is the approach adopted by the 2006 MNA, the provisions of which analytically approach the close-out netting process in its various phases (pre insolvency in respect of the potential conflict between gaming laws and the enforceability of qualified financial

[3] A list of the jurisdictions from which ISDA has obtained netting opinions appears on our website at http://www.isda.org, together with a list of the jurisdictions around the world that have enacted or are considering enacting netting legislation. We also have commissioned and obtained detailed reasoned legal opinions on collateral arrangements under ISDA's Credit Support Documents from over 35 countries. Summaries of the netting opinions have been made available to ISDA members

on a subscription basis via an on-line service known as ***netalytics***. Summaries of the collateral opinions are also available to ISDA members on a subscriptions basis via a comparable on-line service known as *CSAnalytics*. Details of each service are on the ISDA website.

contracts, post insolvency, single-branch and multi-branch), while systematically addressing the legal issues which have been found to apply most commonly (principally, of course, insolvency laws).

The benefits of this approach are numerous:

- the resulting legislation is more accessible and self-explanatory; and
- it is generally more robust than specific legislation which will only address a limited number of known issues but provides no protection against subsequent developments.

Whatever final approach is decided, we suggest, as a first step, that careful consideration should be given to identifying in detail the relevant areas of local law which could potentially conflict with the effectiveness of netting agreements, so that all relevant issues are adequately covered by local legislation. These would typically fall in one or more of the following categories:

- insolvency laws (including provisions of local law enacted for the prevention of insolvency), which most frequently are the primary obstacle;
- any specific mandatory provisions enacted for the protection of debtors generally (*i.e.*, in addition to insolvency law) or for the protection of certain categories of debtors;
- gaming laws; and
- less frequently, general principles of contract law.

1.2 Policy considerations

We suggest that careful consideration be given to identifying any relevant local policy considerations that may be relevant in the context for the adoption of netting legislation, so that the scope of the netting legislation is defined with clarity.

Defining the scope of the legislation has a technical aspect (defining, for example, through the use of legal definitions or legal concepts the transactions or the parties that will benefit from the netting law) but also has a more political aspect, since by defining the scope of the netting law the legislator will necessarily make policy choices. For example, law makers may decide that, because the benefit of netting legislation involves a regime which derogates from the normally applicable insolvency rules, these derogations may only be justified:

- in favor of certain eligible parties (in which case the scope of the legislation will be restricted by reference to such parties – *ratione personae*); and/or
- in certain specific contexts (in which case the scope of the legislation will be restricted by reference to such matters – *ratione materiae*).

In order to be able to define clearly the scope of the netting legislation (see below), those drafting the legislation must decide beforehand a specific policy that will apply in the relevant jurisdiction in relation to the financial transactions covered by the netting legislation. Obviously, these policy choices will be influenced by broader policies reflected in the laws of the relevant jurisdiction.

For example, a jurisdiction in which insolvency law is more favorable to the insolvent party than to its creditors might be tempted to draft netting legislation which reflects this policy.

In formulating its policy choices, law makers in a jurisdiction should, however, distinguish between regulatory policy issues and systemic risk issues. It may be appropriate, by law or regulation, to limit certain types of financial activity to certain types of market participants subject to appropriate conditions and limitations. It does not necessarily, however, make sense to limit the effectiveness of close-out netting by reference to types of market participants. The systemic risk reduction of effective close-out netting benefits all potential market participants, including corporations, insurance companies, special purpose vehicles used for structured financings, governmental authorities, charitable organizations hedging in the market, private individuals and so on. In other words, it reduces credit risk both for solvent and insolvent parties, and reduces the risk of a large insolvency have a "domino" effect on the solvency of other market participants who have dealt with the insolvent.

Although existing netting legislation in some countries does limit eligibility for the benefits of close-out netting to certain categories of market participant, such limitations do not necessarily make sense from a system risk point view. They potentially lead to difficult issues of characterization in relation to certain market participants, therefore creating legal uncertainty, and require periodic updating to reflect the continuing evolution of a dynamic market.

2. DEFINING THE SCOPE OF NETTING LEGISLATION

Once the policy choices in relation to the scope of the netting legislation have been made, those drafting the legislation will need to translate those choices into draft statutory provisions that are consistent with the relevant local legal concepts and categories.

We suggest that the provisions of the 2006 MNA will be helpful in this exercise, as the 2006 MNA may be read as a "check-list" of issues, among other things, permitting legislators that assess whether local legal concepts used to define the scope of the draft legislation are compatible with the overall purpose of the legislation.

2.1 Defining the scope of local legislation *ratione materiae*

While it is in theory possible to draft netting legislation which would cover all types of financial transactions without distinction, the scope of most actual netting legislation will seek to clarify in some way or other the types of financial transaction that benefit from the netting regime. It is clearly important to do this in a way that both provides that greatest amount of legal certainty as to scope but also is capable of accommodating continuing development and innovation in the financial markets.

Section 1 of the 2006 MNA provides a definition of "qualified financial contract" which lists the various types of financial transaction that should ideally be covered. It also includes broad

wording at the end of the definition intended to capture all types of financial transaction of a comparable nature in a way that is flexible enough to accommodate the development of new products. This avoids the need to introduce amending legislation periodically in order to keep pace with the markets, as has happened in a number of countries that introduce early netting statutes that were relatively restricted in scope.

In a number of jurisdictions, the specific style of the definition of "qualified financial contract" in section 1 of the 2006 MNA will probably be felt to be inappropriate insofar as it simply purports to describe extrinsic market realities rather than attempting to cover the same products using existing legal concepts. Legislators may prefer, for example, to consider referring to broad legal concepts such as "forward contracts" or "forward financial instruments". The definition of the financial instruments should be broad enough to cover not only derivative types of transactions but also repurchase transactions and securities lending transactions that should benefit from the same favorable netting regime, as related financial collateral arrangements.

While it is obviously possible to define qualifying transactions using traditional legal concepts in the relevant jurisdiction, legislators should consider the following:

- A single existing category will often be insufficient to cover the broad range of products meant to be covered by the 2006 MNA. For instance, in many civil law jurisdictions, the concept of a forward contract would typically cover derivatives generally but would not cover many products listed by the 2006 MNA ("spot" transactions, securities lending, repurchase transactions, collateral, clearance and settlement transactions, etc.). A combination of concepts would in most cases be inevitable.

- Traditional legal concepts originating decades ago may be inappropriate to describe with clarity and certainty more recent products listed by the 2006 MNA or to cover future financial innovations.

As a result, certain jurisdictions which traditionally tended to use their existing legal concepts have introduced a more pragmatic approach by introducing descriptive language in their statutory provisions on financial matters as this often proves to be the only efficient way to clearly cover a broad range of products which may span traditional legal categories.

In addition to the use of generic language of the type reflected at the end of the definition of "qualified financial contract" in section 1 of the 2006 MNA, Part I section 2 of the 2006 MNA provides that the Central Bank of the relevant jurisdiction should be able to designate as "qualified financial contracts" any agreement or contract in addition to those already listed in the 2006 MNA. Where the Central Bank has this authority, it may use it in relation to a newly developed product, to enhance legal certainty in relation to that developing market.
Such provisions would give more flexibility to the definition of the financial instrument to be covered by the netting legislation. However, local legislators should check whether this suggestion makes sense from a constitutional perspective under local law. If such an approach is not possible under the laws of the relevant jurisdiction, it is particularly important to make sure that the definition of financial instruments covers all types of instruments, currently existing or contemplated, which are supposed to be included in the netting legislation.

Finally, we suggest that the definition *ratione materiae* of the scope of future netting legislation may be a good opportunity to clarify certain legal issues which may interfere with the enforceability of certain financial transactions defined under the netting law. For example, there is some uncertainty under certain legal systems as to the possible characterisation of derivative transactions as unenforceable gaming contracts. Some discussions have also arisen in various jurisdictions as to the possible characterisation of credit protection transactions such as credit default swaps (**CDS**) as guarantee or insurance contracts. Although the objective of the netting law would typically not be to deal with these issues, the definition of qualifying transactions could be the opportunity for the legislator to clarify any identified uncertainty in these respects.

2.2 Defining the scope of local legislation *ratione personae*

After defining which type of financial transactions will be covered by the netting legislation, those preparing draft legislation should, if appropriate, define the parties who will be eligible to benefit from the special netting regime. As set out above, the choice of the eligible parties is important in terms of policy considerations.

The scope *ratione personae* has been, for example, heavily discussed during the drafting and implementation of the European Collateral Directive (the **Directive**), which covers a number of issues related to netting. The Directive offered European Member States the option to exclude non-regulated entities (i.e. mainly corporate entities) from the scope of national legislation implementing the Directive (the so-called "opt-out" of article 1(3) of the Directive). When implementing the Directive, most European jurisdictions decided to include both financial and non-financial entities within the scope of the netting legislation. Certain countries, such as Austria, the Slovak Republic or Sweden, excluded non-financial entities. An alternate solution was adopted by France, which decided that non-financial entities should benefit from the netting regime for transactions entered into with a "regulated" entity (i.e. mainly a financial entity, an investment fund or certain public law governed entities) where these transactions are linked to financial instruments.

The definition of "person" in Part I section 1 of the 2006 MNA may be used as a framework for excluding certain persons from the scope of the netting legislation:

> *""person" includes [individuals], [partnerships], [corporations], [other regulated entities such as banks, insurance companies and broker-dealers], [governmental units];"*

Here again, those preparing draft legislation may consider referring to the exact legal concepts in the law of the relevant jurisdiction to define the relevant persons. For example, if the laws of the relevant jurisdiction provide for a definition of "banks", it would be useful in terms of clarity to refer to this definition.

There are, however, as discussed in part 1.2 of this memorandum, strong policy and practical considerations in favor of adopting as broad a scope as possible for close-out netting legislation and dealing with other policy concerns via financial regulation or other appropriate legislation that does not affect the enforceability of close-out netting against the broad range of financial market participants.

2.3 Netting and collateral arrangements

Once the eligible transactions and eligible parties (if necessary) have been defined, the draft netting legislation needs to define the netting agreements which will be covered. The 2006 MNA gives a broad definition of "netting agreement" which covers master agreement, master-master netting agreement as well as collateral arrangements related to these types of agreements or master-master agreements:

> *""netting agreement" means (i) any agreement between two parties that provides for netting of present or future payment or delivery obligations or entitlements arising under or in connection with one or more qualified financial contracts entered into under the agreement by the parties to the agreement (a "master netting agreement"), (ii) any master agreement between two parties that provides for netting of the amounts due under two or more master netting agreements (a "master-master netting agreement") and (iii) any collateral arrangement related to one or more of the foregoing;"*

It is worth noting that this definition again avoids relying on jurisdiction-specific legal concepts and simply attempts to describe the economic effects intended by the parties in their netting agreement. This approach may prove difficult to translate in certain legal systems that traditionally organize or regulate a specific legal concept of "set-off" (e.g., compensation under the French civil code), which refers to a payment mechanism whereby respective obligations may be discharged. In such cases, it would be worth using the definition of "netting" provided by the 2006 MNA to clarify that netting, for these purposes, is a complex reality which involves:

- the termination or acceleration of the future payment and delivery obligations under the relevant individual transactions (but not the netting agreement itself which should not be required to be terminated);

- the valuation of the respective exposures of the parties thereunder at the time of termination (which may also be thought of as valuing the costs to each party of replacing each terminated transaction with a new transaction concluded with a third party in the market at that time); and

- the computation of a netted termination amount in a single currency reflecting such net exposures as well as the set-off of respective obligations in respect of amounts which were already due and payable.

The 2006 MNA does not list specific types of agreements (e.g., the 2002 ISDA Master Agreement), which avoids restricting the netting regime to specific agreements only. In certain jurisdictions the use of specific domestic documentation governed by the law of the jurisdiction may be common. It is consequently suggested that the netting legislation should adopt a broad definition covering domestic as well as international industry standard documents, irrespective of their governing law and to avoid restrictions limiting, for example, eligible agreements to those approved by a specific authority. In many countries where such restrictions had been initially introduced (e.g., France), they have proved inappropriate both for reasons of principle and for all practical purposes: it is indeed questionable whether any public authority has relevant competence to determine the appropriateness of a given standard to govern privately negotiated contracts. In addition, such restrictions create legal uncertainty, as the relevant public authority will inevitably take considerably more time to approve new documentation or evolutions of existing documentation than the time it will typically take for the markets to adopt such documentation.

In respect of the close-out netting provisions, the netting legislation will, as set out above, need to specify that the eligible transactions which are subject to the close-out netting can be governed by one or more master agreements to allow the use of bridge or master-master-agreements between various agreements governing different types of transactions.

It is worth noting that the definition of "netting agreements" provided by the 2006 MNA refers to collateral arrangements. This allows the close-out netting process to incorporate effectively exposures under related collateral arrangements.

In this respect, the netting law should only refer to the collateral arrangements which are authorized and enforceable under the law of the relevant jurisdiction. The purpose of the netting law is not to define and ensure the validity and enforceability of collateral arrangements. Collateral arrangements raise important legal questions (*e.g.*, type of collateral arrangements, type of collateral which can be used, conditions under which collateral can be taken or given, form of the agreements, perfection, foreclosure, etc.) which need to be addressed, if this has not already been done under the laws of the relevant jurisdiction, by specific legislation.

On the other hand, title transfer collateral arrangements are often integrated into the mechanism of the netting agreement to which they relate (and they are, in the 2006 MNA, included within the definition of "netting agreement" and "qualified financial contract"). It is preferable from a systemic risk point of view to ensure that such arrangements are included within the scope of any netting legislation implemented.

3. CONFIRMING THE ENFORCEABILITY OF NETTING AGREEMENTS

Once the scope of the netting legislation has been defined, adequate operative provisions will be required to effectively implement the purpose described above, namely the enforceability of close-out netting upon the occurrence of any termination event or event of default under the netting agreement, both prior to and following commencement of insolvency proceedings, in each case in accordance with the terms of the parties' contract.

In many jurisdictions, the main obstacles relate to the situation where one of the parties is subject to insolvency proceedings. However, as discussed above, local legislators should make sure that the proposed provisions will also resolve any other legal issue which could potentially interfere with such enforceability.

3.1 General

As set out above, the netting legislation should confirm the enforceability of close-out netting upon the occurrence of any termination event or event of default under the netting agreement, both prior to and following commencement of insolvency proceedings, in each case in accordance with the terms of the parties' contract. Part I section 4(a) of the 2006 MNA expressly confirms that the provisions of a netting agreement will be enforceable in accordance with their terms even if the counterparty is subject to insolvency proceedings.

The 2006 MNA does not give a list of termination events or events of default which would allow the parties to the netting agreement to terminate the underlying transactions. These events will be

provided by the netting agreement entered into by the parties. When referring to the termination of the transactions, we suggest that local legislators use the approach adopted by the 2006 MNA and simply refer to the agreement of the parties.

Netting legislation should not require "termination" of the netting agreement itself since only transactions terminate. The netting agreement should survive so that its netting provisions can effectively be performed. The netting law should also provide that the inclusion of non-eligible transactions under the netting agreement would not destroy close-out netting for the remaining eligible transactions under the netting agreement. For example, if the netting law refers to "forward financial instruments", the inclusion in the netting agreement of spot transactions which do not constitute forward financial instruments should not prevent the parties from being able to close-out the transactions which comply with the definition of forward financial instruments and should not affect the validity of the netting agreement. In this respect, Part I section 4(i) of the 2006 MNA refers expressly to the fact that a netting agreement should be enforceable even if this netting agreement contains transactions that are not "qualified financial contracts". In this case, pursuant to the 2006 MNA, the netting arrangement should only apply to the agreements, contracts or transactions that fall within the definition of "qualified financial contract".

Finally, once the relevant transactions are terminated, the provisions of the netting agreements provide for the calculation of a single net amount which, in principle, will be owed by one party to the other. Consequently, the netting legislation should specify that the only obligation or entitlement due to or from a party to a netting agreement upon close-out netting of transactions is its net obligation or entitlement as determined in accordance with the terms of the netting agreement. This is the objective of Part I sections 4(b) and 4(c) of the 2006 MNA. Again, it is stressed that the netting legislation should not limit itself to confirming the availability of set-off of the separate obligations owed under each transaction, but should instead recognize the single net obligation or entitlement for all transactions which results from the close-out netting process.

3.2 Enforceability outside insolvency proceedings

It is quite likely that most of the civil law jurisdictions would recognize the enforceability of netting agreements outside the scope of insolvency proceedings.

However if this is not the case, the netting legislation should ensure the enforceability of close-out netting and collateral arrangements upon the occurrence of any termination event or event of default under the netting agreement in accordance with the terms of the parties' contract. Consequently, the netting law should set out clearly that despite the rules which could conflict with the effectiveness of the netting and collateral provisions, these provisions will be enforceable. In this respect the 2006 MNA only sets out in Part I section 3 that qualified financial contracts shall not be unenforceable by reason of laws relating to gaming contracts.

Such provisions will only need to be included in the netting law if the netting and collateral provisions are not enforceable without such clarification. If the relevant law already sets out that similar netting mechanism or collateral arrangements are already enforceable in respect of counterparties which are not subject to insolvency proceedings, the netting law would not need to make such specification as it would be redundant and could create some uncertainty as to why such provision is necessary. The legislator will consequently need to take into consideration the legal provisions which already regulate contractual netting in the local jurisdiction either to draft

accordingly the netting law, if contractual netting is already authorized or to specify clearly that the netting legislation should be an exception to the more general contractual netting provisions if it is necessary.

In addition, legislators should also ensure that the netting legislation will recognize the enforceability of the netting arrangements if the defaulting party is subject to any attachment procedures from third parties.

3.3 Enforceability in the case of insolvency proceedings

The protection of the netting legislation is crucial where one party to the qualifying transaction is subject to insolvency proceedings. This explains the particular focus in the 2006 MNA on enforceability vis-à-vis an insolvent party and any insolvency official.
Insolvency law, in particular in countries where the insolvency provisions are more favorable to the insolvent debtor than to the creditors of the insolvent party, might not authorize close-out netting of transactions where one party is subject to insolvency proceedings.

Prohibition of Termination

Typically, insolvency laws might limit the effectiveness of contractual termination provisions when they are triggered on the basis of the opening of the insolvency proceedings. Given the importance of termination in the close-out netting process, the 2006 MNA goes beyond the general affirmation of the enforceability of netting agreements provided in Part I section 4(a) and provides in section 4(d) that a liquidator shall not be able to prevent the termination of any qualified financial contracts or the acceleration of any payment owed under these qualified financial contracts.

"Cherry-Picking"

In addition, under insolvency legislation, the liquidator often has the right to require the continuation of or, on the contrary, to repudiate transactions entered into by the insolvent party. When these prerogatives exist, they create a risk of "cherry-picking" whereby the liquidator could potentially decide to continue any transaction which is "in-the-money" for the insolvent party while repudiating any "out-of-the money" transactions. This would obviously undermine the entire netting mechanism. Legislators should accordingly consider introducing in the netting legislation provisions similar to the provisions of Part I section 4(d) of the 2006 MNA to prevent the liquidator from "cherry-picking" only specific transactions within the netting agreement.

Limitations on set-off

Many bankruptcy laws limit the availability of set-off in an insolvency. For example, in certain civil law jurisdictions, respective obligations are only available for set-off when they have fallen due; even when they are due, set-off will only be possible with respect to respective obligations which either arise under the same agreement or are otherwise strongly interconnected (this is sometimes referred to as the "connexity" requirement). Such requirements might jeopardize the effectiveness of netting agreements. The provisions of the netting law will need to address these issues as suggested in Part I section 4(e) of the 2006 MNA, which provides for the recognition of set-off in a way which is compatible with the mechanisms of typical netting agreements.

Preferences

The netting law will also need to ensure that any payment or transfer of collateral made in respect of the transactions during any "preference period" or "suspect period" are not treated as a preference and are consequently not avoidable, as this is frequently the case under bankruptcy law. Part I section 4(f) of the 2006 MNA expressly sets out that a liquidator of an insolvent party may not avoid a transfer or a payment on the ground of it constituting a preference or transfer during a suspect period by the insolvent party to the non-insolvent party.

Other Considerations

The 2006 MNA takes the approach of affirming in each case where insolvency provisions could conflict with the netting provisions the validity of the netting and collateral arrangements over these insolvency provisions. In this respect, civil law jurisdictions might prefer not to list each and every situation which could be problematic but instead to override or disapply all the relevant provisions of the insolvency law which would apply to the relevant type of counterparty in case of insolvency proceedings.

French law, for example, specifies in an article of its monetary and financial code that close-out netting is valid under French law and in a subsequent article confirms that none of its insolvency provisions may interfere with the application of the first article.

Consequently, by "disapplying" all the insolvency law provisions instead of affirming in certain specific situations that the netting and collateral arrangements will be valid, French law sets out clearly that insolvency law may not be used to challenge the principle of the validity of close-out netting and precludes the risk of failing to enumerate any specific cases which could be problematic.

In any event, as set out above, Part I section 4 should be used by those preparing legislation as a "check-list" when "disapplying" insolvency law provisions which might conflict with the netting provisions. Please note that the list of issues addressed by the 2006 MNA is not exhaustive and other issues may need to be considered under the laws of the relevant jurisdiction.

Finally, it is important for the netting legislation to include in the reference to the insolvency proceedings all types of insolvency proceedings. It should, for example, include judicial proceedings but also voluntary arrangements with creditors or the inability of the debtor to pay its debts as they become due. Insolvency proceedings should consequently cover bankruptcy, liquidation (judicial or voluntary), winding-up, reorganisation, composition, administration, receivership, rehabilitation, conservatorship and any similar or additional measure under the laws of the relevant jurisdiction. In addition, the netting legislation should also cover "all similar proceedings" to ensure that any new types of proceedings which could be introduced under the relevant law will be included in the scope of the netting legislation.

4. MULTIBRANCH NETTING

Netting legislation should permit multibranch netting when a master agreement is entered into with a party which has a head office in a jurisdiction and various branches in other jurisdictions, including in the local jurisdiction. Part II of the 2006 MNA provides detailed provisions that are

intended to ensure the effectiveness of multibranch netting in the event of the cross-border insolvency of a multibranch bank.

Statutory provisions comparable to Part II of the MNA are particularly important in jurisdictions that provide for a ring-fencing of the assets and/or liabilities of an insolvent local branch. Such ring-fencing would otherwise potentially undermine the effectiveness of the netting mechanism, which is supposed to operate globally on the basis of all respective obligations and entitlements of the parties, irrespective of the place of booking of individual transactions.

The multibranch provisions of the 2006 MNA are based on the New York banking law provisions that expressly enforce multibranch close-out netting for derivatives transactions in a constructive attempt to reconcile the ring fencing of New York branches and the interest in enforcing multibranch close-out netting.

It is necessary for local legislators to consider whether ring-fencing applies in their own jurisdiction and, if so, consider the appropriateness of provisions similar to those set out in Part II of the 2006 MNA. Obviously, if ring fencing does not apply, then these provisions should not be necessary.

As we have been over the past 20 years, ISDA is always willing to provide practical support, including information regarding global financial market practice, to national lawmakers, regulators and other government officials engaged in developing netting legislation or other law reform initiatives relating to the financial markets. For further information in relation to ISDA's activities in this regard or to request such support or information, please do not hesitate to contact David Geen ( ), General Counsel, Katherine Tew Darras ( ), General Counsel, Americas, or Peter Werner ( ), Policy Director.