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Mr Pierre Delsaux
Chairman, Expert Group on Securities
Head of Unit, Directorate G - Financial Markets, Internal Market DG
European Commission
B-1049 Bruxelles/Brussels

Dear Mr Delsaux,

Expert Group on Securities

The International Swaps and Derivatives Association, Inc. ("ISDA") is an international financial trade association whose membership comprises more than 600 of the world's largest commercial, merchant and investment banks, corporations, government entities and other institutions. ISDA's members represent a broad cross section of the institutions that act as dealers and end-users of swaps and other privately negotiated derivative instruments in over 46 jurisdictions worldwide.

ISDA is committed to promoting the development of sound risk management practices. Its work includes efforts to ensure adequate legal and regulatory treatment of OTC derivatives transactions. In particular, ISDA has worked with regulators in jurisdictions around the world to promote the legal enforceability of the close-out netting mechanism in the ISDA Master Agreement, which is the leading standard-form documentation for international OTC derivatives transactions.

Netting Legislation in the European Union

We would note at the outset that ISDA welcomes the efforts of the European Commission's Expert Group on Securities to identify legislative issues regarding financial regulation in the EU and provide strategies for EU countries to develop and harmonise their financial regulations after the completion of the Financial Services Action Plan in 2005. We support any initiative you may wish to consider aiming at facilitating the adoption of close-out netting legislation. We share your interest particularly in accession countries, currently contemplating the adoption of close-out netting legislation. Coordination and harmony among legal regimes is necessary for netting across jurisdictions to be consistent.

Most EU member countries have now adopted netting legislation, and many of the potential acceding countries have provided or are in the process of adopting statutory support for close-out netting. However, there are several reasons why ISDA believes that the attention of the Expert Group on Securities on this topic would be particularly relevant and timely.

Firstly, there are issues relating to the enforceability of close-out netting that may be better addressed on a regional or multi-jurisdictional basis. For example, the subject of multibranch netting will most likely arise in multiple or parallel cross-border insolvency proceedings. Monitoring of the legislative efforts past, present and future is necessary if the statutory support for netting across jurisdictions is to be consistent. Conflicts cannot necessarily be resolved by the legislation of any one country, which may be lacking in extraterritorial effect.

Further, there are inconsistencies among the current netting regimes in EU member countries (and in acceding countries too). For example, France and Spain require at least one party to be a financial institution, and Belgium requires both parties to be financial institutions, for close-out netting protections to apply. With regard to coverage of derivatives products, a number of EU member states, including Finland, France, Norway and Spain, exclude derivative products from coverage under the netting legislation that are covered in most other EU jurisdictions.

Many of the inconsistencies can be explained by the fact that the relevant laws were adopted at different points in time and without co-ordination with other jurisdictions. Until recently, no comprehensive collection of netting provisions was available that could easily be accessed. Benefiting from the experience of more than a decade of legislative reform in support of close-out netting, there is an opportunity now to reflect on the lessons learned.

Accordingly, the Expert Group on Securities may wish to consider whether an expanded EU would benefit from a Netting Directive designed to provide minimum standards or "benchmarks" for effective and efficient close-out netting legislation and promote greater harmonisation in approach. ISDA would support such an initiative and stand ready to provide technical assistance in connection with it. Directives on solvency ratios and collateral specify that member countries must ensure that their solvency ratio and collateral legislation work in line with any close-out netting legislation, but stop short of requiring a minimum standard of netting legislation to be in place.

What should the minimum standards be? Four themes that ISDA has emphasised when advocating the adoption of close-out netting legislation are: (1) ensuring that any statutorily supported netting occurs in accordance with the parties' agreed terms, especially where these reflect a global industry standard; (2) technical distinctions that need to be considered when distinguishing netting from set-off; (3) the need to ensure broad and flexible protections for a dynamic market; and (4) the relation between close-out netting and credit support, including collateral and title transfer arrangements.

In this regard, we would comment in more detail as follows:

- I. ***Enforceability Based on the Contract.*** Netting legislation should ensure the enforceability of close-out netting following the occurrence of any contractually agreed termination event or

event of default under a netting agreement, both pre- and post-insolvency, in each case *in accordance with the terms of the parties' agreement*. Reliance by the parties on the expressly agreed terms of their contract, and in particular where these represent standard terms on which business is conducted in the derivatives market, is a key issue for ISDA members. In other words, market participants who engage in derivatives transactions pursuant to the ISDA Master Agreement will be concerned if any particular netting legislation can be read to subordinate provisions of the contract to potentially differing statutory requirements.

- A. ***Enforceability in Bankruptcy.*** In light of uncertainty arising from existing insolvency regimes, which in many cases were adopted before the emergence of the derivatives market, and in the absence of court decisions on point, derivatives market participants will take great comfort from a clear statutory recognition that close-out netting will be enforceable and will take precedence over conflicting member state insolvency law where appropriate.
1. Where member state insolvency law provides that the liquidator may assume or repudiate contracts ("cherry-picking"), the netting legislation should limit such assumption or repudiation to the net amount due under the netting agreement.
 2. Where member state insolvency law prohibits set-off, the netting legislation should provide that close-out netting is not a prohibited form of set-off.
 3. Where member state insolvency law provides for a suspect period, the netting legislation should provide that payments under eligible transactions are not to be treated as preferences where such payment was not made with intent to hinder, delay or defraud other creditors.
 4. "Insolvency proceedings" should be broadly defined to include both proceedings that now exist or may in future arise, including those arising under similar regimes in other jurisdictions. The Bankruptcy Event of Default in the 2002 ISDA Master Agreement may be a good starting point for assessing a statutory definition.
- B. ***Outside of Bankruptcy.*** Netting should also be enforceable (in accordance with the terms of the contract) outside of bankruptcy. The netting legislation should, if necessary, be written to provide that such legislation also takes precedence over gaming or similar laws that could invalidate netting agreements on the basis that they are gaming or otherwise unlawful contracts.
- C. ***Trades Terminate; Agreements Survive.*** It is an important issue for ISDA members that any netting legislation should not require "termination" of the agreement. Under ISDA documentation, only trades or transactions terminate and the agreement survives so that the netting provisions in it are enforceable.

- II. ***Technical Distinctions.*** 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 agreement.
 - A. The netting legislation should not provide for set-off of the separate obligations owed under each transaction, but should instead create one net obligation for all transactions.
 - B. The netting legislation should specify that a netting agreement and all eligible transactions under the netting agreement constitute a single contract.
 - 1. The netting legislation should 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.
 - 2. In addition, where collateral arrangements cover some transactions which are eligible transactions and some which are not, the collateral arrangements should remain protected with respect to the eligible transactions.
- III. ***Flexibility.*** We believe that netting legislation should be broad and flexible enough to include a wide range of financial products.
 - A. If the benefits of netting are restricted to "eligible transactions", which, in principle, is a restriction that we would not support, then that term should be defined as broadly as possible and subject to the greatest possible flexibility to update.
 - 1. The list of eligible transactions should include the derivatives transactions in Annex A, and any additional derivatives transactions commonly entered into at the time the legislation is drafted.
 - 2. The definition of eligible transactions should also include title transfer collateral arrangements to ensure that, where a netting agreement includes such arrangements, obligations to return collateral of equivalent value are netted with obligations under the derivatives transactions.
 - B. If the benefits of netting are restricted to an "eligible counterparty", then that term should be broadly defined to include all potential beneficiaries of close-out netting legislation, including those outside the financial sector.
 - 1. The netting legislation should not exclude corporations, insurance companies, special purpose vehicles, wealthy individuals or others that could potentially benefit from close-out netting of over-the-counter derivatives transactions entered into on a bilateral basis.
 - 2. "Netting agreement" should be broadly defined to include single agreements, master agreements, master-master agreements and any related collateral arrangements.

C. An alternative would be to provide netting benefits for transactions subject to qualifying netting agreements, like the ISDA Master Agreement. This appears to be the approach taken in Hungary's netting legislation and contemplated by pending legislation in the Czech Republic and Slovakia.

IV. ***Credit Support.*** The derivatives market views collateral arrangements and title transfer provisions as significant risk-mitigation tools (while recognising that their relevance to a particular transaction is fact-specific). At a minimum, netting legislation should not undermine the enforceability of collateral arrangements under member state law, including member state law implementing the European Collateral Directive. Particular attention should be paid to Article 7 of the European Collateral Directive, which requires member states to reinforce their close-out netting legislation especially in relation to title transfer collateral arrangements.

A. Collateral and title transfer arrangements should be included in any definition of protected eligible transactions so that they are also exempt from usual insolvency rule protections such as stays or avoidance by liquidators.

B. Collateral arrangements in support of netting agreements should be exempt from any conflicting member state collateral law requirements that the collateral taker obtain consent from, or provide notice to, other parties or liquidators prior to the realisation of collateral.

We hope that our comments are helpful to you during your considerations. ISDA wholeheartedly would like to bring this issue to the attention of the Expert Group on Securities in discussing the financial legislation in the EU and, for the reasons presented above and in light of the issues discussed, hopes that you will consider the need for an EU Directive on close-out netting. We look forward to the opportunity to work closely with the Commission in this area. Any questions or requests for further information on any of the foregoing should be directed to the undersigned.

Yours sincerely,

Kimberly Summe, General Counsel, ksumme@isda.org

CERTAIN DERIVATIVE TRANSACTIONS UNDER
The ISDA Master Agreements

Basis Swap. A transaction in which one party pays periodic amounts of a given currency based on a floating rate and the other party pays periodic amounts of the same currency based on another floating rate, with both rates reset periodically; all calculations are based on a notional amount of the given currency.

Bond Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a bond of an issuer, such as Kingdom of Sweden or Unilever N.V., at a specified strike price. The bond option can be settled by physical delivery of the bonds in exchange for the strike price or may be cash settled based on the difference between the market price of the bonds on the exercise date and the strike price.

Bullion Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified number of Ounces of Bullion at a specified strike price. The option may be settled by physical delivery of Bullion in exchange for the strike price or may be cash settled based on the difference between the market price of Bullion on the exercise date and the strike price.

Bullion Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price or a fixed rate and the other party pays periodic amounts of the same currency or a different currency calculated by reference to a Bullion reference price (for example, Gold-COMEX on the New York Commodity Exchange) or another method specified by the parties. Bullion swaps include cap, collar or floor transactions in respect of Bullion.

Bullion Trade. A transaction in which one party agrees to buy from or sell to the other party a specified number of Ounces of Bullion at a specified price for settlement either on a “spot” or two-day basis or on a specified future date. A Bullion Trade may be settled by physical delivery of Bullion in exchange for a specified price or may be cash settled based on the difference between the market price of Bullion on the settlement date and the specified price.

For purposes of Bullion Trades, Bullion Options and Bullion Swaps, “Bullion” means gold, silver, platinum or palladium and “Ounce” means, in the case of gold, a fine troy ounce and in the case of silver, platinum and palladium, a troy ounce.

Buy/Sell-Back Transaction. A transaction in which one party purchases a security (in consideration for a cash payment) and agrees to sell back that security to the other party (in consideration for the original cash payment plus a premium).

Cap Transaction. A transaction in which one party pays a single or periodic fixed amount and the other party pays periodic amounts of the same currency based on the excess, if any, of a specified floating rate (in the case of an interest rate cap) or commodity price (in the case of a commodity cap) in each

case that is reset periodically over a specified per annum rate (in the case of an interest rate cap) or commodity price (in the case of a commodity cap).

Collar Transaction. A collar is a combination of a cap and a floor where one party is the floating rate or floating commodity price payer on the cap and the other party is the floating rate or floating commodity price payer on the floor.

Commodity Forward. A transaction in which one party agrees to purchase a specified quantity of a commodity at a future date at an agreed price and the other party agrees to pay a price for the same quantity to be set on a specified date in the future. The payment calculation is based on the quantity of the commodity and is settled based, among other things, on the difference between the agreed forward price and the prevailing market price at the time of settlement.

Commodity Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified quantity of a commodity at a specified strike price. The option can be settled either by physically delivering the quantity of the commodity in exchange for the strike price or by cash settling the option, in which case the seller of the option would pay to the buyer the difference between the market price of that quantity of the commodity on the exercise date and the strike price.

Commodity Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price and the other party pays periodic amounts of the same currency based on the price of a commodity, such as natural gas or gold, or a futures contract on a commodity (for example, Light Sweet Crude Oil on the New York Mercantile Exchange); all calculations are based on a notional quantity of the commodity.

Credit Protection Transaction.¹ A transaction in which one party pays either a single fixed amount or periodic fixed amounts or floating amounts determined by reference to a specified notional amount, and the other party (the credit protection seller) pays either a fixed amount or an amount determined by reference to the value of one or more loans, debt securities or other financial instruments (each a “Reference Obligation”) issued, guaranteed or otherwise entered into by a third party (the “Reference Entity”) upon the occurrence of one or more specified credit events with respect to the Reference Entity (for example, bankruptcy or payment default). The amount payable by the credit protection seller is typically determined based upon the market value of one or more debt securities or other debt instruments issued, guaranteed or otherwise entered into by the Reference Entity. Credit protection transactions may also be physically settled by payment of a specified fixed amount by one party against delivery of specified Reference Obligations by the other party. A credit protection transaction may also refer to a “basket” of two or more Reference Entities.

Credit Spread Transaction. A transaction involving either a forward or an option where the value of the transaction is calculated based on the credit spread implicit in the price of the underlying instrument.

Cross Currency Rate Swap. A transaction in which one party pays periodic amounts in one currency based on a specified fixed rate (or a floating rate that is reset periodically) and the other party pays

¹ Some market participants may refer to credit protection transactions as credit swaps, credit default swaps or credit default options.

periodic amounts in another currency based on a floating rate that is reset periodically. All calculations are determined on predetermined notional amounts of the two currencies; often such swaps will involve initial and or final exchanges of amounts corresponding to the notional amounts.

Currency Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified amount of a given currency at a specified strike price.

Currency Swap. A transaction in which one party pays fixed periodic amounts of one currency and the other party pays fixed periodic amounts of another currency. Payments are calculated on a notional amount. Such swaps may involve initial and or final payments that correspond to the notional amount.

Equity Forward. A transaction in which one party agrees to pay an agreed price for a specified quantity of shares of an issuer, a basket of shares of several issuers or an equity index at a future date and the other party agrees to pay a price for the same quantity of shares of an issuer to be set on a specified date in the future. The payment calculation is based on the number of shares and can be physically-settled (where delivery occurs in exchange for payment) or cash-settled (where settlement occurs based on the difference between the agreed forward price and the prevailing market price at the time of settlement).

Equity Index Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right to receive a payment equal to the amount by which an equity index either exceeds (in the case of a call) or is less than (in the case of a put) a specified strike price.

Equity Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) shares of an issuer or a basket of shares of several issuers at a specified strike price. The option may be settled by physical delivery of the shares in exchange for the strike price or may be cash settled based on the difference between the market price of the shares on the exercise date and the strike price.

Equity or Equity Index Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price or a fixed rate and the other party pays periodic amounts of the same currency or a different currency based on the performance of a share of an issuer, a basket of shares of several issuers or an equity index, such as the Standard and Poor's 500 Index.

Floor Transaction. A transaction in which one party pays a single or periodic amount and the other party pays periodic amounts of the same currency based on the excess, if any, of a specified per annum rate (in the case of an interest rate floor) or commodity price (in the case of a commodity floor) over a specified floating rate (in the case of an interest rate floor) or commodity price (in the case of a commodity floor).

Foreign Exchange Transaction. A transaction providing for the purchase of one currency with another currency providing for settlement either on a "spot" or two-day basis or a specified future date.

Forward Rate Transaction. A transaction in which one party agrees to pay a fixed rate for a defined period and the other party agrees to pay a rate to be set on a specified date in the future. The payment

calculation is based on a notional amount and is settled based, among other things, on the difference between the agreed forward rate and the prevailing market rate at the time of settlement.

Interest Rate Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to receive a payment equal to the amount by which an interest rate either exceeds (in the case of a call option) or is less than (in the case of a put option) a specified strike rate.

Interest Rate Swap. A transaction in which one party pays periodic amounts of a given currency based on a specified fixed rate and the other party pays periodic amounts of the same currency based on a specified floating rate that is reset periodically, such as the London inter-bank offered rate; all calculations are based on a notional amount of the given currency.

Physical Commodity Transaction. A transaction which provides for the purchase of an amount of a commodity, such as coal, electricity or gas, at a fixed or floating price for actual delivery on one or more dates.

Repurchase Transaction. A transaction in which one party agrees to sell securities to the other party and such party has the right to repurchase those securities from such other party at a future date.

Securities Lending Transaction. A transaction in which one party transfers securities to a party acting as the borrower in exchange for a payment or a series of payments from the borrower and the borrower's obligation to replace the securities at a defined date with identical securities.

Swap Option. A transaction in which one party grants to the other party the right (in consideration for a premium payment), but not the obligation, to enter into a swap with certain specified terms. In some cases the swap option may be settled with a cash payment equal to the market value of the underlying swap at the time of the exercise.

Total Return Swap. A transaction in which one party pays either a single amount or periodic amounts based on the total return on one or more loans, debt securities or other financial instruments (each a "Reference Obligation") issued, guaranteed or otherwise entered into by a third party (the "Reference Entity"), calculated by reference to interest, dividend and fee payments and any appreciation in the market value of each Reference Obligation, and the other party pays either a single amount or periodic amounts determined by reference to a specified notional amount and any depreciation in the market value of each Reference Obligation.

A total return swap may (but need not) provide for acceleration of its termination date upon the occurrence of one or more specified events with respect to a Reference Entity or a Reference Obligation with a termination payment made by one party to the other calculated by reference to the value of the Reference Obligation.

Weather Index Transaction. A transaction, structured in the form of a swap, option, cap, collar, floor or some combination thereof, between two parties in which the underlying value of the transaction is based on a rate or index pertaining to weather conditions, which may include measurements of heating, cooling, precipitation and wind.