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Notre Réf:

MEMORANDUM FOR ISDA® MEMBERS

Definition of "Fully Transferable Obligation" in the ISDA Restructuring Supplement

The International Swaps and Derivatives Association, Inc. ("ISDA") published its Restructuring Supplement to the 1999 ISDA Credit Derivatives Definitions (the "Definitions") on May 11, 2001 and a Commentary on the Restructuring Supplement on May 24, 2001. Both are available from the ISDA website at www.isda.org.

Some ISDA members have raised a question regarding the proper interpretation of the definition of "Fully Transferable Obligation". The term "Fully Transferable Obligation" is used in Part I (Restructuring Maturity Limitation) of the Restructuring Supplement. The relevance of this in the context of the Restructuring Maturity Limitation provision is explained in some detail in the Commentary.

In brief, for purposes of physical settlement in circumstances where Restructuring Maturity Limitation applies, a Deliverable Obligation must be a Fully Transferable Obligation. In the case of a Bond, this means that the Bond is Transferable as defined in Section 2.19(b)(v) of the Definitions. In the case of any other type of Deliverable Obligation, for example, a Loan, it must be "capable of being assigned or novated to all Eligible Transferees without the consent of any person being required". ISDA have asked us to confirm for members, as explained in the Commentary, that whether an obligation is a Fully Transferable Obligation is determined without regard to any legal or regulatory restriction that is independent of the terms of the Deliverable Obligation. The ISDA members involved in drafting the Restructuring Supplement and the related Commentary were conscious of the fact that many Loans contain a restriction on assignment or other transfer of the Loan and were of the view that the market would benefit from increased liberalization of such restrictions.

As the definition of "Fully Transferable Obligation" makes clear, in determining whether or not a Deliverable Obligation is capable of being assigned or novated to an Eligible Transferee, one takes "into account *only* the terms of the Deliverable Obligation and any related transfer or consent documents which have been obtained by the Buyer" (emphasis added). In other words, one does not take into account for this purpose statutory or regulatory restrictions such as banking regulations that prohibit certain types of entities from holding loans.

A list of the names of partners and their professional qualifications is open to inspection at the above office. The partners are either solicitors in the United Kingdom or lawyers registered in other jurisdictions.

*Une liste des associés indiquant leurs qualifications professionnelles est disponible à l'adresse ci-dessus.
Les associés sont des "solicitors" au Royaume-Uni ou des avocats inscrits dans d'autres pays. Toque JO22*

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As noted in the Commentary:

Such restrictions may, in fact, prevent the Deliverable Obligation from being assigned to a person or group of persons included in the definition of Eligible Transferee in connection with the settlement of the Credit Derivative Transaction. The Deliverable Obligation will nevertheless be considered a Fully Transferable Obligation for the purpose of Section 2.29 as long as the terms of the Deliverable Obligation permit transfer to an Eligible Transferee.

A hypothetical fact pattern to illustrate the principles above is set out in the Annex to this memorandum.

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EXAMPLE TO ILLUSTRATE OPERATION OF THE RESTRUCTURING SUPPLEMENT IN A HYPOTHETICAL FACT PATTERN

1. Background

- (1) Bank A, as the Buyer, and Bank B, as the Seller, each incorporated, licensed as a banking institution and acting through an office in Country X, have entered into a credit default swap transaction ("Transaction One"). Transaction One is evidenced by a Confirmation incorporating the Definitions and the Restructuring Supplement.
- (2) Bank B, as the Buyer, has also entered into a credit default swap transaction in relation to the same Reference Entity, which is also located in Country X, and otherwise on the same terms ("Transaction Two") with Company C, as the Seller, which is incorporated, licensed as an insurance company (and not as a banking institution), and acting through an office in Country X. Transaction Two is also evidenced by a Confirmation incorporating the Definitions and the Restructuring Supplement.
- (3) Each Confirmation is governed by an ISDA Master Agreement (Multicurrency - Cross Border) between the relevant parties subject to English law or to New York law. The parties in each case have specified "Restructuring Maturity Limitation Applicable" in the relevant Confirmation.
- (4) In each Confirmation: the Obligation Category is Borrowed Money; the Obligation Characteristics are Pari Passu Ranking and Not Contingent; the Settlement Method is Physical Settlement; the Deliverable Obligation Category is Borrowed Money; and the Deliverable Obligation Characteristics are Pari Passu Ranking, Not Contingent, Assignable Loan and Transferable.¹
- (5) Bank A has acted as lender to the Reference Entity under a loan agreement governed by the law of Country X. The loan agreement falls within the definition of "Loan" in the Definitions, satisfies the Obligation Characteristics, and satisfies the Deliverable Obligation Characteristics. The Loan is a fully drawn unmatured term loan facility at all relevant times during this example. Bank A, as lender, has no outstanding obligations to the Reference Entity, as borrower, under the Loan.
- (6) There is no specific provision in the Loan dealing with assignment or novation of the lender's rights and/or obligations to third parties. Under the general law of obligations of Country X, in the absence of such a provision, rights are freely assignable without consent of the relevant obligor.
- (7) There is a banking monopoly in Country X so that only licensed banking institutions are permitted to lend to non-affiliated entities or to acquire and hold loans to non-affiliated entities originated by a third party. Under local law, the banking monopoly would be construed as prohibiting a licensed banking institution from transferring a loan to an entity that is not licensed as a banking institution.

2. Occurrence of a Restructuring

- (1) A Restructuring Credit Event has occurred in relation to Bonds issued by the Reference Entity, and it is the only Credit Event specified in the Credit Event Notice delivered by Bank A (as the Buyer) to Bank B (as the Seller) under Transaction One and in the Credit Event Notice delivered by Bank A (as the Buyer) to Company C (as the Seller) under Transaction Two. In each case, the Buyer wishes to treat the Loan as a Deliverable Obligation in the Portfolio. The question arises whether the Loan may be included in the Portfolio under the terms of the Restructuring Supplement. This, in turn, depends on whether the Loan would be a Fully Transferable Obligation.

¹ As provided in Section 2.19(b)(v) of the Definitions, the "Transferable" Obligation Characteristic only applies to obligations that are not Loans, for example, Bonds.

- (2) The answer, based on the hypothetical facts above, would be yes in relation to both Transaction One and Transaction Two.
- (3) The Loan itself is an Assignable Loan. It is therefore a Fully Transferable Obligation because it is capable of being assigned without the consent of the borrower to any third party under the terms of the Loan in accordance with its governing law.
- (4) Under Transaction One, the Seller, Bank B, is a licensed banking institution in Country X, and therefore capable of taking delivery of the Loan under the bank regulatory regime in Country X. Under Transaction Two, the Seller, Company C, is not a licensed banking institution in Country X and therefore not capable of taking delivery of the Loan under the bank regulatory regime in Country X. The banking monopoly thus prevents the Bank B, as the Buyer under Transaction Two, from including the Loan as part of the Portfolio for purposes of satisfying its Physical Settlement obligations.
- (5) Nonetheless, in relation to each of Transaction One and Transaction Two, the Loan is a Fully Transferable Obligation. The fact that, under Transaction Two, the Seller may not take delivery of the Loan is a matter of banking regulation in Country X and is *not* due to any restriction under the terms of the Loan itself.
- (6) It does not matter for the purpose of this example that the banking monopoly would prevent the Loan from being assigned to most of the types of entities that fall within the definition of "Eligible Transferee" (including an entity such as Company C). The definition of "Fully Transferable Obligation" requires simply that the Deliverable Obligation, *by its own terms*, permits transfer to any person falling within the definition of "Eligible Transferee". In this case, the Loan, by its own terms, permits transfer to *any* third party (and therefore any person falling within the definition of "Eligible Transferee") without restriction.

Notes:

1. *As always when using ISDA documentation, the parties themselves must ensure that any legal or regulatory requirements that are not governed strictly by the terms of the contract are observed.*
2. *We assumed for purposes of this example that (a) the Loan is silent on the ability of the lender to assign its rights under the Loan and (b) under the law of Country X, in the absence of a specific contractual restriction, contractual rights are freely assignable without the consent of the relevant obligor. If we had assumed instead that under the law of Country X, in the absence of a specific contractual permission, contractual rights are not assignable without consent of the obligor, then the Loan would not be a Fully Transferable Obligation. This is despite the fact that the Loan is silent on the question of assignment of the lender's rights. The contract must be interpreted in accordance with its governing law, the law of Country X, and under that law rights may not be assigned without the consent of the obligor.*