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Rome, 31 May 2006

Dear Sirs,

On behalf of the International Swaps and Derivatives Association, Inc. (**ISDA**), and as authors of the *ISDA Netting Opinion* and the *ISDA Collateral Opinion* in respect of Italian law aspects[1], we would like to present the following observations in respect of the document for public consultation published on your website named "Implementation of the New International Prudential Framework (Basel II, the New Accord and New EU Directive on capital requirements for credit institutions and investment firms) – Methods of reduction of credit risk and securitisation" (the **Document**).

We are submitting these observations so that they might be taken into account in the preparation of the final version of the Document as well as in respect of the interpretation of the regulations analysed below.

Our observations concern, in particular, paragraph 2.4 of the Document (*Master Netting Agreements*) which discusses the enforceability of *close-out netting* only if the conditions indicated in the Document are recognised, that is, in relation to transactions which (i) fall within the meaning of Article 203 of the Legislative Decree no. 58 of 24 February 1998 (**TUF**), or (ii) fall within the scope of the Legislative Decree of 21 May 2004 no. 170 which implements the Directive 2002/47/EC on financial collateral arrangements (**Decree 170**).

If the indicated conditions do not apply, the Document does not seem to take into consideration how the *close-out netting* clause operates in the event of a restructuring or liquidation of a credit institution.

[1]Namely, the legal opinions prepared on appointment by ISDA, respectively, "Memorandum of law prepared for the International Swaps and Derivatives Association, Inc. on the enforceability under Italian law of the Termination, Close-Out and Multibranch Netting Provisions of the 1992 and 2002 ISDA Master Agreements" (dated 15 July 2004 and updated on 3 May 2006, in the light of the recent changes in law and regulation); and "Memorandum of law prepared for the International Swaps and Derivatives Association, Inc. on the validity and enforceability under Italian law of Collateral Arrangements under the ISDA Credit Support Documents" (dated 20 October 2004).

In particular, the Document does not mention the provisions of Article 95-ter, paragraph 2, of Legislative Decree no. 385 of 1 September 1993 (the **Banking Law**) which provides for a derogation from the application of Italian law in the case of admission of credit institutions to insolvency proceedings. Article 95-ter sets out that in respect of both restructuring procedures or liquidation, "*agreements for set-off and novation ... are disciplined according to the governing law of the contract*". The failure to analyse Article 95-ter has particular importance in relation to the fact the that automatic and immediate termination of any pending transactions pursuant to Article 203 of TUF could be subjected to a delay in the event of an order for the continuation of the business of a credit institution in the context of proceedings for liquidation pursuant to Article 90 of the Banking Law.

1. Origin of the term set-off in Article 95-ter of the Banking Law

Article 95-ter of the Banking Law has been introduced by the Legislative Decree no. 197 of 9 July 2004 (the **Decree 197**). The Decree 197 has been adopted to implement the Directive 2001/24/EC of 4 April 2001 relating to the recovery and liquidation of credit institutions (**Directive 2001/24/EC**).

The Italian (text) version of Directive 200/24/EC in Article 25 provides that the law of contract (*lex contractus*) applies exclusively to the agreements for set-off and novation.

The use of the term *set-off* in Article 95-ter of the Banking Law and Article 25 of the Directive 2001/24/EC seems to originate from the Italian (text) version of the Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 (**Directive 2000/12/EC**). As affirmed in the third paragraph of the preamble to the Directive 2001/24/EC, Directive 2001/12/EC defines the European Community legislative framework relating to the taking up and pursuit of the business of credit institutions.

In relation to the treatment of off-balance-sheet items in the context of the calculation of the solvency ratio of the credit institutions, the Italian (text) version of the Directive 2000/12/EC sets forth that the Member States are required by the respective competent authorities to reach a uniform evaluation of agreements for set-off and novation. However, the English (text) version of the Directive 2000/12/EC sets forth that the uniform evaluation by the competent authority must be made in respect of agreements for novation and other netting agreements ("*contractual netting*").

In light of the above observations, we believe that a distinction must be made between the terms "set-off" and "netting", and in particular "close-out netting" for financial transactions outstanding in circumstances where one of the parties has been made subject to insolvency proceedings. Notwithstanding certain similarities, conceptually, *netting* comprises the possibility to close out all pending transactions with the *defaulting party* within a single legal relationship in order to determine the quantum of a single claim (as opposed to two or more reciprocal claims) owed between the parties. On the other hand, *set-off* recognises both obligations to pay between the parties deriving from different contractual transactions, which may be extinguished, fully or partially, by deducting from the amount owed to each party the amount which is owed to the other.

In light of the above, we would note that there is no direct Italian translation for the term/concept of *netting*, and that the distinction between *netting* and *set-off* has been the source of misunderstandings in Italian and Community Law in the past as is illustrated by the following two examples.

The first example arises in respect of the implementation in Italy of the Directive 98/26/EC on settlement finality in payment and securities settlement systems (**Directive 98/26/EC**). The Italian (text) version of the Directive 98/26/EC, in Article 2(k), refers to the term *netting* to define the conversion into one single debt or credit position of the debts or credits resulting from transfer orders, with the effect that only the net amount may be claimed. However, the Legislative Decree no. 210 of 12 April 2001 implementing the Directive 98/26/EC translates the term *netting* as *compensazione* (Article 1(f)).

The second example refers to Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings (the **Regulation n. 1346/2000**). The Regulation n. 1346/2000 uses, in the English (text) version, the term *set-off* in Article 4 and in the preamble (27). In both cases, the term used in the Italian (text) version of the regulation is *compensazione*. Furthermore, the preamble (27) of the Regulation n. 1346/2000, in the English (text) version, refers to "*position-closing agreements and netting agreements*", whilst the Italian (text) version in respect of the same terms refers to "*liquidation of contracts and compensazioni*". This seems to indicate that in the Italian (text) version of the Regulation n. 1346/2000, the term *compensazione* is used in relation to both *set-off* and *netting*.

Notwithstanding the exclusive reference to *compensazione*, we believe that in respect of the regulations mentioned above, a distinction should be made as to when the term needs to be interpreted as mere *compensazione* (i.e. set-off) and when apart from set-off, the term also comprises the possibility of immediate "close out" (i.e. termination) of transactions due to the insolvency of the counterparty.

For the sake of completeness we note that Decree 17 officially defines the *close-out netting* clause in relation to the financial collateral arrangements and indicates the effects thereof, but does not strip the concept of *netting* from its determined mechanism of operation.

2. Concept of *close-out netting* pursuant to the ISDA Master Agreement

As you are aware, the standard contract as drafted by ISDA (the **ISDA Master Agreement**), by means of inserting appropriate clauses which provide for *close-out netting*, increases the protection for financial market participants when their counterparty becomes insolvent. The *close-out netting* clause provides that upon the occurrence of an event which in the contract is defined as *default*, there will be a termination of the pending transactions and payment of the net amount in favour of the party which results as creditor. The effect of the clause is the reduction of the parties' credit exposure (to each other) and consequently the reduction of risk of a systemic crisis due to the insolvency of one of the entities.

According to a literal interpretation of Article 95-ter of the Banking Law and in the event of insolvency it could seem that only the validity of set-off as provided for under a *master netting agreement* (such as, *inter alia*, the ISDA Master Agreement) is ensured, but not the possibility of *close-out* of all pending transactions between the parties. For the sake of completeness, we believe that it is not possible to allow for the application of the law of contract (*lex contractus)* (and therefore, of the *close-out netting* clause) to arrangements included in an *master netting agreement,* pursuant to the provisions of Article 95-ter of the Banking Law which makes reference to "*transactions effected in a regulated market*" given that derivative financial transactions concluded pursuant to an ISDA Master Agreement are negotiated *over the counter*.

We also note that Article 95-ter of the Banking Law omits to provide that the agreements for set-off and novation shall be governed *solely* by the law of contract (*lex contractus)*: consequently, such omission could, in theory, be interpreted as leaving open the possibility that Italian insolvency laws (regulating restructuring and liquidation) might apply.

3. *Close-out netting* and supervision of banks

The Guidelines set out by the Bank of Italy (*Banca d'Italia*) implementing the Directive 2000/12/EC recognise the reduction of the risk in the contractual agreement which creates "*one single obligation, which comprises all transactions (between the parties) so that in the event of insolvency, bankruptcy, liquidation or in respect of any similar event, the bank has the right to receive or the obligation to pay only the net amount comprised of the positive and/or negative values attributed by the market to the single transactions between the parties"* (Title IV, Capital 2 Appendix B).

Notwithstanding the wording of the instructions which makes reference to any contractual transaction of *compensazione*, the phrase above seems to describe the complete mechanism of *close-out netting*, including the right to terminate individual transactions.

Furthermore, the Bank of Italy to date seems to concur with the application of the regulation mentioned above in respect of a *netting agreement* such as the ISDA Master Agreement. We believe, therefore, that if an Italian court were called upon to interpret Article 95-ter of the Banking Law it ought to recognise the term *compensazione* with the wider meaning articulated in this letter. In such a case, the possibility to close-out transactions, including in the context of commencement of restructuring or liquidation procedures, would be recognised. In the light of these considerations, it would be opportune if the Document was amended accordingly so as to take into consideration the current practice adopted by the Bank of Italy in relation to *netting agreements* such as the ISDA Master Agreement.

Finally, we note that recognising the term *compensazione* as per Article 95-ter of the Banking Law as including the concept of *netting* is necessary in order to acknowledge the possibility of terminating a contract with a counterparty in liquidation even in the case as set out in Article 90 of the Banking Law, namely when the competent authority has decided that the entity should continue to carry on its business or certain divisions of its business. In fact, in the absence of a financial collateral arrangement, the provisions of Article 203 of the TUF would not be sufficient in order to ensure the enforceability of netting in these circumstances, until such time as the continuation ordered pursuant to Article 90 comes to an end.

4. Insolvency and law of contract (*lex contractus*)

Notwithstanding the omission of the term *solely* in Article 95-ter of the Banking Law (i.e. *agreements for set-off and novation … are disciplined according to the governing law of the contract*"), we are of the view that an Italian court should still recognise that, with Directive 2001/24/EC, the intention of the European legislature was to remove the question of enforceability of a *netting agreement* from domestic insolvency law and refer exclusively to the governing law of the netting agreement.

In other words, we believe that the Directive 2001/24/EC indicates that the domestic insolvency law must necessarily recognise the validity of the contractual provisions, in a manner which allows for the full operation of *close-out netting*.

Therefore, if an Italian bank were subject to insolvency proceedings in Italy and English law, by choice of the parties, were to govern the ISDA Master Agreement, we believe that Italian insolvency law would not be relevant. In view of the provisions of Article 25 of the Directive 2001/24/EC we believe that English insolvency law would also have no relevance and thus would have no impact on the operation of the contract made between the parties. Therefore, the only law governing the contract should be *solely* that chosen by the parties to the *netting agreement*, namely the law of contract indicated by the parties.

English insolvency law could only be relevant if there were English insolvency proceedings commenced in the United Kingdom in relation to an Italian Bank, which clearly cannot be the case under the Directive 2001/24/EC as implemented in Italy through Decree 197.

Where the ISDA Master Agreement is governed by New York law, i.e. non-EU law, in the case of admission of an Italian bank to insolvency proceedings in Italy, we believe that, from the perspective of the Italian courts, New York insolvency law would only be relevant to the treatment of the *close-out netting* provisions of the ISDA Master Agreement to the extent that proceedings in relation to the Italian bank were actually commenced in New York.

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We would be grateful for an opportunity to discuss these matters with you to present or provide any further clarification that might be necessary for a better understanding of our note in respect of the acceptance and recognition of the *close-out netting* clause in the event of an insolvency event in relation to credit institutions.

As presented above, such recognition would need to derive from an interpretation of Article 95-ter of the Banking Law recognising that:

(i) the term *compensazione* is indented to comprise *netting*, namely, the right of the *non-defaulting party* to terminate all transactions under an ISDA Master Agreement immediately upon occurrence of such an event of default, which provides for this remedy, such as insolvency of the counterparty; and

(ii) the law of contract (*lex contractus*) exclusively governs any novation and other netting agreements without reference to the relevant domestic insolvency law which might cause delay in terminating outstanding transactions between the parties.

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Kind regards,

G. Massimiliano Danusso

Lisa Curran