

# ISDA

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24 May 2005

Mr. John D.K. Lawrence  
Director  
Financial Services Commission  
P.O. Box 1575  
The Valley  
Anguilla, British West Indies

Dear Mr. Lawrence:

Thank you for your letter dated 5 April 2005 with respect to the development of close-out netting legislation in Anguilla. On behalf of the International Swaps and Derivatives Association, Inc. ("ISDA"), I am grateful for the opportunity to discuss the provisions of the Model Netting Act published by the ISDA in 2002, attached to this letter as Annex A.

As indicated in our letter to you dated 1 April 2005, ISDA's member firms are supportive of the development of netting legislation in Anguilla. Financial institutions and institutional investors have indicated to ISDA that the development of netting legislation would enhance legal certainty with respect to Anguillan counterparties in financial transactions executed with non-Anguillan counterparties.

The Model Netting Act published by ISDA was designed to assist governments in the development of legislation which will ensure that the protections of netting and collateral arrangements are available to participants in their respective financial markets. While there are no laws or regulations in Anguilla that explicitly indicate that close-out netting would not be enforceable, the financial community's view is that the adoption of specific legislation that recognizes the enforceability of bilateral and multibranch close-out netting provisions and the enforceability of certain collateral arrangements is the most effective method in which to achieve such legal certainty.

## The Model Netting Act – A Summary of the Key Provisions

The Model Netting Act is divided into two Parts: Part I addresses the enforceability of bilateral netting and collateral arrangements and Part II addresses multibranch netting.

*Part I – Bilateral Netting.* The first part of the Model Netting Act presents the essential elements of a bilateral netting regime. Like many netting statutes, the Model Netting Act contains a list of transaction types which fall within its scope, referred to as “qualified financial contracts”. The length and detail of the list of transaction types illustrates how much innovation has occurred within the derivatives markets in the last two decades. New financial products are continuously developed and to maintain a current and adequately detailed list would require frequent amendment of any netting statute. In order to avoid this problem, the Model Netting Act uses a functional approach. Under the functional approach, any financial contract pursuant to which money payment or delivery obligations that have a market or an exchange price are due to be performed at a certain time or within a certain period of time would be treated as a qualified financial contract. This definition should include any and all derivatives transactions documented under, for example, an ISDA Master Agreement because any derivatives transaction is time sensitive. In addition, the Model Netting Act gives the central bank the power to designate additional transactions or types of transactions as qualified financial contracts. This permits the list to be updated through regulatory action without requiring the passage of a new law.

Section 4 of Part I of the Model Netting Act contains the key provisions which establish the enforceability of netting agreements. For the purposes of the Model Netting Act, a netting agreement includes: (i) any netting agreement in connection with one or more qualified financial contracts; (ii) any master-master netting agreement (*i.e.*, a netting agreement which encompasses other netting agreements); and (iii) any collateral arrangement related thereto.

Section 4 creates a carve-out from other regulations which protect netting agreements from regulatory stays which might otherwise be imposed upon the insolvency of one of the parties to the netting agreement. In addition, Section 4 includes provisions which affirm that the only obligation or entitlement due to or from a party to a netting agreement is its net obligation or entitlement as determined in accordance with the terms of that agreement. It also specifically limits the powers of a liquidator to cherry pick individual transactions covered by a netting agreement by protecting the ability of the parties to the netting agreement to terminate and close out their qualified financial contracts. Any power of a liquidator to assume or to repudiate contracts is limited to assumption or repudiation of the net amount due under the netting agreement.

Section 4 also prevents laws generally prohibiting set off from being interpreted so as to interfere with the operation of netting (specifically the offset of close-out values within the confines of the netting agreement) and protects payments under qualified financial contracts from being treated as preferences in the absence of evidence that such payment was made with the intent to hinder, delay or defraud other creditors. Finally, it provides that where certain transactions covered by a netting agreement are not qualified financial contracts, the validity of the netting agreement with respect to those transactions which are qualified financial contracts will not be jeopardized.

*Part I – Collateral Arrangements.* In addition to the provisions addressing the enforceability of bilateral close-out netting, Part I of the Model Netting Act also contains provisions which deal with the enforceability of collateral arrangements in insolvency. The majority of the protections contained in the Model Netting Act apply to a wide variety of collateral arrangements, including

title transfer collateral arrangements (arrangements which involve the outright transfer of collateral) and collateral arrangements involving a security interest or pledge, guarantees and other forms of credit enhancement. As discussed below, certain protections apply specifically to title transfer collateral arrangements. The range of collateral which may be transferred or pledged pursuant to a collateral arrangement under the Model Netting Act is also quite broad.

There are two key protections provided for collateral arrangements under the Model Netting Act. First, collateral arrangements are included in the definition of “netting agreement”. The effect of this inclusion is that the enforceability of collateral arrangements, whether by pledge or title transfer, is protected in the same manner as that of other netting agreements. This, for example, includes the protections against stays and avoidance by liquidators. Second, title transfer collateral arrangements are included in the list of qualified financial contracts. This permits obligations under a title transfer collateral arrangement to return collateral of equivalent value to a counterparty to be netted under a netting agreement which covers both the collateral arrangement and other derivatives transactions. This would, for example, apply to most credit support annexes based on title transfer which are commonly used in conjunction with ISDA Master Agreements in the privately negotiated derivatives markets.

In addition, the Model Netting Act contains several other provisions which protect collateral arrangements in the event of an insolvency. In order to ensure that collateral takers may realize collateral quickly, specific provisions protect collateral takers from requirements that they obtain consent from other parties or liquidators or provide notice prior to the realization of collateral in relation to a netting agreement. As it does for netting agreements, Section 4 also provides that, where a collateral arrangement covers some transactions which are qualified financial contracts and some which are not, the collateral arrangement will remain protected with respect to the qualified financial contracts.

*Part II – Multibranch Netting.* In Part II of the Model Netting Act, specific issues arising under netting agreements that include multibranch provisions are addressed. The Model Netting Act provisions are based on Section 618-a(2)(c)-(e) of the New York Banking Law provisions adopted in 1993 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. Under the Model Netting Act, following the termination of a multibranch master agreement that is a qualified financial contract, the single net termination amount is calculated on both a global and local basis.

The global net amount is the amount owed by or to the foreign party as a whole if all transactions across all branches subject to the multibranch netting agreement are considered (the “Global Net Payment Obligation” or “Global Net Payment Entitlement”). The local net amount is the amount owed by or to the foreign party after netting only the transactions entered into by the local branch or agency of the foreign party (the “Branch/Agency Net Payment Obligation” or “Branch/Agency Net Payment Entitlement”). The liquidator shall only be liable to pay to a non-defaulting counterparty the lesser of the Global Net Payment Obligation and the Branch/Agency Net Payment Obligation. Likewise, when a counterparty owes a net amount pursuant to a repudiated or terminated qualified financial contract, the liquidator may demand from the counterparty a payment of the lesser of the Global Net Payment Entitlement and the

Branch/Agency Net Payment Entitlement. Any amounts to be collected or paid by the counterparty are reduced by amounts that have been collected or paid in other jurisdictions pursuant to the same qualified financial contract, thereby foreclosing the potential for double recovery or payment.

Under the multibranch provisions of the Model Netting Act, the insolvency officials in each country would exercise insolvency jurisdiction over the assets present in that country, but would recognize at the same time the interests of foreign representatives of creditors. From the perspective of equal treatment of creditors, the multibranch provisions of the Model Netting Act contain - at least for the particular creditors to which they apply - a distribution principle that produces a predictable and clearly determinable result. Legal certainty in these situations is often preferable to elaborate attempts to provide equal treatment.

Conclusion

The Model Netting Act may be either enacted in full or utilized as a resource by regulators and legislators in designing their own legislation. The Model Netting Act permits participants in the privately negotiated derivatives markets to take advantage of the protections of close-out netting and of collateralization of exposures through the outright transfer of title in collateral. The development of such legislation provides an opportunity to protect current market participants from risks associated with international insolvencies and to attract foreign participants and counterparties to the Anguillan marketplace.

Again, thank you for the opportunity to submit this letter. Certainly do not hesitate to contact the undersigned at 212-901-6000 if you have any queries or require any assistance.

Sincerely,



Robert G. Pickel  
Executive Director and Chief Executive Officer

**2002 MODEL NETTING ACT**

**Part I : Netting**

**1. Definitions**

In this Act:

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

"collateral" means:

- (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 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 security arrangement 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 or an irregular pledge; 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 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 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 terminated and/or accelerated under (i);
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(iii) the conversion of any values calculated or estimated under (ii) into a single currency; and

(iv) the offset of any values calculated under (ii), as converted under (iii);

"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 thereunder 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;

"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], [other regulated entities such as banks, insurance companies and broker-dealers], [governmental units];

"qualified financial contract" means any financial contract, including any terms and conditions incorporated by reference in any such financial contract, pursuant to which payment or delivery obligations that have a market or an exchange price are due to be performed at a certain time or within a certain period of time. Qualified financial contracts include (without limitation):

- (a) a currency, cross-currency or interest rate swap agreement;
  - (b) a basis swap agreement;
  - (c) a spot, future, forward or other foreign exchange agreement;
  - (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) equity derivatives, such as equity or equity index swaps, equity options and equity index options;
  - (j) credit derivatives, such as credit default swaps, credit default basket swaps, total return swaps and credit default options;
  - (k) energy derivatives, such as electricity derivatives, oil derivatives, coal derivatives and gas derivatives;
  - (l) weather derivatives, such as weather swaps or weather options;
  - (m) bandwidth derivatives;
  - (n) freight derivatives;
  - (o) carbon emissions derivatives;
  - (p) a spot, future, forward or other commodity contract;
  - (q) a repurchase or reverse repurchase agreement;
  - (r) an agreement to buy, sell, borrow or lend securities, such as a securities lending transaction;
  - (s) a title transfer collateral arrangement;
  - (t) an agreement to clear or settle securities transactions or to act as a depository for securities;
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- (u) any other agreement similar to any agreement or contract referred to in paragraphs (a) to (t) with respect to reference items or indices relating to (without limitation) interest rates, currencies, commodities, energy products, electricity, equities, weather, bonds and other debt instruments and precious metals;
- (v) any derivative or option in respect of, or combination of, one or more agreements or contracts referred to in paragraphs (a) to (u); and
- (w) any agreement or contract designated as such by the Bank under this Act;

"title transfer collateral arrangement" means a security arrangement 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 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 or contract, or type of agreement or contract, 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 and lotteries.

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

(a) **General rule.** The provisions of a netting agreement will be enforceable in accordance with their terms against the insolvent party and, where applicable, against a guarantor or other person providing security for the insolvent party and will not be stayed, avoided or otherwise limited by any action of the liquidator, by any other provision of law relating to bankruptcy, reorganization, composition with creditors, receivership, conservatorship or any other insolvency proceeding the insolvent party may be subject to or by any other provision of law that may be applicable to the insolvent party, subject to the conditions contained in the applicable netting agreement.

(b) **Limitation on obligation to make payment or delivery.** The only obligation, if any, of a 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.** The only right, if any, of a 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 will not prevent the termination and/or acceleration of any payment or delivery obligations or entitlements under one or more qualified financial contracts entered into under 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 offset of close-out values, market values, liquidation values or

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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 pursuant to 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 pursuant to 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 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 contracts that fall within the definition of qualified financial contract in terms of 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 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 contracts that fall within the definition of netting agreement or

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qualified financial contract entered into under a netting agreement in terms of 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 contract.

(iv) For the purposes of this section, the term netting agreement shall include the term multibranch netting agreement (as defined in Part II), provided, however, that in a separate insolvency of a branch or agency of a foreign party (as defined in Part II) 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 branch or agency and the non-insolvent party 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 branch or agency and the non-insolvent party 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 agreements provided for payments to either party, upon termination thereof 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;

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"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, 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 under a multibranch netting agreement shall be calculated as of the date of the termination of 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 of the insolvent branch or agency or the liquidator under this section shall be reduced by any amount otherwise paid to or received by the 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 any party thereunder shall be reduced by the fair market value or the amount of any proceeds of collateral that secures and has been applied to satisfy the obligations of the foreign party pursuant to the multibranch netting agreement.

(b) No limitation on the insolvent party's right to receive payment based on the terms of the multibranch netting agreement. In the event that netting under the applicable multibranch netting agreement results in a branch/agency net payment entitlement, notwithstanding any provision in any such contract that purports to effect a forfeiture of such entitlement, the liquidator may make written demand upon the party to such contract for an amount not to exceed the lesser of (x) the global net payment entitlement and (y) the branch/agency net payment entitlement.

(c) Limitation on the insolvent 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 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 or the amount of any proceeds of collateral that secures and has been applied to satisfy the obligations of the non-insolvent party pursuant to such multibranch netting agreement to the foreign party.

(d) 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

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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 insolvent party.