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Our Ref: ICM:367801.2

17th September, 1999

The Bond Market Association
40 Broad Street, 12th Floor
New York
NY 10004

Attention: Kenrick Isaac, Regulatory Policy Analyst

Dear Sirs,

Exposure Draft Cross-Product Master Netting Agreement (the "Agreement")

On behalf of the International Swaps and Derivatives Association, Inc. ("**ISDA**"), we are writing in response to the Notice of Publication and Request for Comment issued by The Bond Market Association (the "**Association**") on July 9, 1999. A working group consisting of representatives of ISDA members has reviewed the Agreement together with the associated Guidance Notes and the purpose of this letter is to reflect the working group's comments.

1. General Comments

Generally, the ISDA working group commends the work of the Association in producing the Agreement. It is consistent with the interests of all participants in the financial markets to attempt to reduce credit risk by increasing contractual netting coverage across traditionally distinct product areas. In particular, the working group notes that the development of a bilateral cross-product netting agreement of this type is seen as one of several available means of achieving cross-product netting.

One of the concerns voiced by the working group, however, relates to the timing of the Association's initiative. Many publishers of standard form documentation for the financial markets, including ISDA, are in the process of conducting fundamental reviews of their documentation library. To the extent that the Association's effort would benefit from the results of ISDA's work, ISDA expects to be able to report out of the working group before the end of this year and would aim to agree relevant changes to its documentation in advance of its March, 2000 AGM. A number of members of the working group have commented that satisfactory answers to the issues raised in this letter should be agreed before a firm publication date is fixed, and that it might be helpful to harmonise thinking on these matters.

2. Structural Comments

(a) *Legal Opinions*

Many of the forms of agreement listed in part I of the Schedule to the Agreement are supported by legal opinions which confirm the efficacy of their contractual netting provisions. The Agreement effects a number of amendments to these agreements and concern has been expressed that these amendments might raise questions with respect to aspects of those supporting opinions. Clearly,



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The partners are either solicitors or registered foreign lawyers.*

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this is as much an issue for the trade associations that sponsor the underlying agreements as it is for the Association. However, a prominent "health warning" somewhere in the Guidance Notes might be appropriate to highlight this issue.

The working group notes that the Association anticipates obtaining legal opinions confirming the enforceability of the Agreement when governed by English law and New York law. What precisely is the nature of those opinions? While we understand that an opinion would not be delivered until the Agreement is finalised, it would be helpful to know the nature of counsel's preliminary conclusions, and any qualifications to the opinion, assuming the Agreement were adopted in essentially its present form. In addition, is it anticipated that netting opinions will be obtained from other jurisdictions? We assume that you have considered the need to update any opinions obtained if reliance is to be placed upon them for regulatory purposes.

(b) *Guarantees and Collateral*

The working group notes that the draft Agreement attempts to deal with collateral arrangements in respect of the Principal Agreements in Part VIII. A number of issues arise:

- (i) Question 3 in the Request for Comments is important. The potential danger in amending existing security arrangements in respect of only Closed-Out Agreements is that the Closed-Out Agreements will only be identifiable at the moment of, or shortly after, default. This seems a particularly sensitive time at which to be amending security arrangements, particularly if the default is insolvency - related.
- (ii) Has any attention been paid to possible re-registration or re-filing requirements arising from the amendment of existing security arrangements?
- (iii) In relation to the second alternative in Part VIII, what exactly is this intended to cover? Would these types of issues not be dealt with in the underlying agreements?
- (iv) The Agreement appears not to deal with guarantees. Where obligations in respect of any of the Principal Agreements are guaranteed, presumably the benefits of the guarantee would be lost if a Settlement Amount for the relevant Principal Agreement were wrapped up into the set-off/netting effected by the Agreement. Perhaps the Guidance Notes should refer to the advisability of obtaining a guarantee in respect of the Agreement itself where any of the Principal Agreements have the benefit of a guarantee.
- (v) Presumably, the types of "title transfer" credit support arrangements used, for example, in the ISDA Credit Support Annex governed by English law are intended to be dealt with by way of the definition of "Settlement Amount". Is this correct?

(c) *Amendments to Principal Agreements*

This is an issue that would be difficult to resolve. It arises from the fact that the Agreement effectively amends the terms of existing (and possibly subsequently executed) Principal Agreements. The concern relates to the fact that, particularly in a litigious situation, ready access to complete documentation is important. Having distinct strands, together making up the contractual relationship between two parties, may add to confusion at a time when certainty and speed are paramount.

(d) *Set-Off and Conditionality Provisions in Principal Agreements*

Some concern has been expressed in relation to set-off clauses and conditionality provisions in certain of the Principal Agreements. It may be that a Settlement Amount in relation to a Closed-

Out Agreement is reduced or, possibly, never arises due to reliance on such provisions in circumstances where the set-off or the condition relied upon arises in connection with another Principal Agreement. We note that this point is considered in the Guidance Notes, with a suggestion that set-off clauses, at least, in the Principal Agreements might be overridden. Please note that the set-off clauses in the Principal Agreements may well have been drafted more broadly than the set-off that would be effected by the Agreement and that overriding the set-off clauses in this context may actually prejudice the non-defaulting party's position.

(e) *Mismatching Default Provisions*

A key element of the Agreement is Section 2 which allows a "Closing-Out Party" to treat the occurrence of a "Close-Out Event" under one Principal Agreement as a Close-Out Event under one or more other Principal Agreements. The risk identified by the working group is that users of the Agreement might overlook the fact that this provision may effectively override grace periods and/or other provisions that have been specifically negotiated in certain of the Principal Agreements. In most cases, of course, this is simply a feature of the Agreement's structure: it effectively builds a zero-threshold cross-default clause into each Principal Agreement. Thus, a failure to pay under a principal Agreement with a two day grace period will allow the non-defaulting party to close-out under another Principal Agreement where the equivalent grace period is, say, five days. This may well be a desirable result, but it should be pointed out in the Guidance Notes.

A slightly less obvious example, and one that we feel should be highlighted, is the potential for mismatch in relation to events of default in the different Principal Agreements that attempt to catch the same events or circumstances. For example, the ISDA Master Agreement contains (at Section 5(a)(vii)(4)) an event of default triggered by the institution of bankruptcy proceedings, as do both the PSA/ISMA Global Master Repurchase Agreement (the "GMRA") (at paragraphs 10(a)(iv) and 2(a)(iv)) and the Association's Master Securities Loan Agreement (the "MSLA" at Section 11.5(ii)). Under the ISDA Master Agreement, however, there is a general "cure period" of 30 days which, although present in the GMRA is slightly more restricted in its application there. In the MSLA the equivalent cure period is 15 days. Because of Section 2 of the Agreement, where each of the ISDA Master Agreement, the GMRA and the MSLA are specified as Principal Agreements, the ISDA Master Agreement will be affected by the more limited cure periods in the GMRA and the MSLA: the non-defaulting party under the GMRA or the MSLA will be entitled to close-out under the ISDA Master Agreement notwithstanding that by its own terms, the close-out provisions of the ISDA Master Agreement would not have been triggered.

We understand that efforts will be made to harmonise various provisions across the range of standard industry agreements. To the extent that any consensus achieved as a result of these efforts may require further changes to the Agreement, this may be another good reason to delay finalising the Agreement.

Again, a prominent health warning in the Guidance Notes may be the most appropriate means of addressing this issue.

(f) *Inclusion of Certain Agreements May be Inappropriate*

In line with point (e) above, certain working group members have highlighted the dangers of including certain underlying master agreements (in particular the International Deposit Netting Agreement) (the "IDNA") within the Agreement. The IDNA has extremely limited termination provisions, in recognition of the potentially fatal liquidity issues associated with acceleration of interbank deposits. It is suggested that a banking regulator would not look kindly on inclusion of the IDNA under the Agreement where a more expansive range of defaults or termination events

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(credit downgrades, changes of control and possibly even tax events) could effectively lead to acceleration under the IDNA.

Again, perhaps a suitably clear health warning is sensible in these circumstances.

(g) *Close-Out*

Section 2 allows the Closing Out Party to designate which Principal Agreements are to be subject to a Close-Out Event. Have possible bank regulatory concerns been addressed? There is some scope for suggesting that the provision may be regarded by regulators as a "walkaway clause" in the same way that conditionality clauses have been challenged. A distressed financial institution may find that the clause will be used against it - rather than by it - and will result in the close out of those Principal Agreements on which the distressed dealer or bank owes money but not in the close out of agreements under which the distressed regulated financial institution is owed money.

(h) *Duplication of Notices*

We are concerned that there are numerous occasions in the course of a close-out under the Agreement when a Closing-Out Party will be required to deliver notices. For example, statements appear to be required in respect of each Settlement Date (Section 4.1) as well as in respect of the Final Settlement Amount (Section 4.4.(a)). These notice obligations seem to be in addition to those required by the terms of the Closed-Out Agreements (such as the Section 6 notices under the ISDA Master Agreement) - assuming we are reading Section 3.1 correctly to the effect that you comply with all close-out mechanics (including notice provisions) in the Closed-Out Agreements. This duplication of notices seems to be inconsistent with the move in the market generally to try to minimise notice requirements. Various groups, including ISDA, are reviewing the notice provisions in their published forms of agreements with a view to rationalising them. It may be advisable to await a resolution on the issue before layering over a new set of notices.

(i) *Automatic Termination*

There has been some discussion of the relevance of automatic termination provisions. Where one or more of the Principal Agreements contains an automatic termination provision in order to ensure the enforceability of close-out netting in problematic insolvency regimes, presumably this approach would need to be carried through into the Agreement. Has any attention been paid to this issue during the development of the Agreement?

3. *Drafting Comments*

(a) *Close-Out Event*

We are unsure why the term Close-out Event is drafted so broadly. Admittedly, parties to the Agreement are able to carve certain events out of the definition (for example, Termination Events under an ISDA Master Agreement that would not necessarily result in the termination of all transactions if acted upon) by means of Part II of the Schedule. However, if parties fail to make use of Part II, it is conceivable that a non-credit - related event (such as a tax event or an illegality) could trigger full close-out under the terms of the Agreement. The use of the words "or substantially all" in lines 8 and 9 seems unnecessary. Surely the types of events we would want to trigger full close-out could only ever be those that entitle a party to close-out all, but not some only, of the transactions outstanding under a Principal Agreement.

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(b) *US Representations*

The elective US representations in Sections 5.2 and 5.3 should not appear in the body of the Agreement but should be set out in the Guidance Notes.

(c) *Tax Gross-Up*

The working group is not convinced that the deemed application of tax gross-up provisions from a named Principal Agreement would be helpful. It should be made clear that the relevant gross-up provision applies to payments due under the Agreement itself and does not override equivalent provisions in the other Principal Agreements.

(d) *Base Currency*

The enclosed mark-up of the Agreement suggests a number of amendments in relation to the treatment of the terms "Base Currency" and "Base Currency Equivalent". The specific concerns are (i) that there is currently no detail on how the Closing-Out Party is to designate or specify the Base Currency - presumably, this should be a specification required in the Close-Out Notice; (ii) that the drafting in 3.2 should be clearer; and (iii) that the payment instructions in Part VI will have to acknowledge that the Base Currency has not yet been decided.

(e) *Settlement Amount*

We have suggested amendments to the definition of the term "Settlement Amount". On a more general note, we believe that more clarity is required in this definition, particularly as to what constitutes "margin, collateral or credit support" in this context. For example, are common-law or contractual set-off rights included? Is credit support provided under a keep well or liquidity agreement covered?

We also enclose copies of the Agreement and selected pages from the Guidance Notes, marked with a number of other suggested amendments that, we hope, do not require further elaboration. As to the Guidance Notes themselves, many of the points discussed above will also be relevant, but the working group has not focussed on their style or the level of guidance given

Please feel free to contact Richard Tredgett of Allen & Overy (tel. +44 171 330 3000, fax +44 171 330 9999) or Bob Pickel of ISDA (tel. 212 332 1200, fax 212 332 1212) if you would like to discuss these comments, or if there are any other issues that you would like to discuss.

Yours faithfully,

Allen & Overy

cc: Paul Saltzman, The Bond Market Association
Robert Pickel, ISDA