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BY EMAIL AND FAX

Ms Davida Lachman-Messer
Deputy Attorney-General
29 Salah-A-Din Street
91010 Jerusalem
Israel

London, 28th July 2005

Dear Ms Lachman-Messer,

As you know, the International Swaps and Derivatives Association, Inc. ("**ISDA**") is an international financial trade association whose membership comprises over 650 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 transactions in jurisdictions worldwide (47 countries).

ISDA's commitment to promoting the development of sound risk management practices, and its particular interest in the legal framework for over-the-counter derivatives and close-out netting in Israel, were set out in more detail in a letter sent to you and Mr. Yoav Lehman of the Bank of Israel on 13 December 2004.

In a letter dated 2 March 2005, you kindly invited ISDA to provide assistance and input to the process of advancing netting legislation in Israel, and we are delighted to do so. In the interest of the imminent deadlines we are sending our comments by fax and e-mail.

We would first like to emphasise that we believe the approach you are taking is an intelligent one. Changes that we suggest may, in some cases, reflect translation, rather than substantive differences. There may be points reflected in our comments that arise from our reading of the English translation of the draft law that has been furnished to us, and those points may not be relevant when considered in the context of the Hebrew language version of the draft. We

apologise in advance for our reliance on the English translation and any confusion that may result.

The comments which follow are also reflected in the suggested amendments that we have made to the text of the draft law in the attached document. Our hope is that these general points will make the thinking behind the changes we propose clear.

1) *Trades terminate; agreements survive*
It is an important issue for ISDA members that any netting legislation should not require "termination" of the agreement. Under the ISDA Master Agreement, only *trades or transactions* terminate following an insolvency or other event of default; the agreement survives. Indeed, it is the survival of the agreement (and particularly Section 6 contained therein) that ensures the survival and enforceability of the netting arrangements. Similarly, certain indemnities (e.g., currency, enforcement costs) survive, as do, for example, provisions relating to notice and dispute settlement. In the draft text, establishing this essential distinction merely calls for the simple change of one word ("including" becomes "or") at several points.

2) *Distinction between entitlements and expectations*
The parties' remedy under the ISDA Master is not to accelerate a debt, but rather to *liquidate* a claim based on *replacement cost*, i.e., the cost of obtaining the same level of protection in the market. Accordingly (and technically speaking), the valuation is not of the asset lost, which because of its "flaw" is probably worthless. Valuation is instead a measure of the cost of replacing a trade (i.e., obtaining "cover") with equivalent economic and material terms entered into with a healthy third party.

The methodology for closing out under ISDA documentation has evolved considerably over the 20 years that ISDA terms have been used, and particularly important changes in this regard, borrowing on the experience of crisis management and court decisions during the last decade, were introduced in the 2002 ISDA Master Agreement. As a result, the concept of "Close-out Amount" replaces the "Market Quotation" and "Loss" payment measures reflected in the 1992 ISDA Master Agreement. Close-out Amount is a user-driven innovation and is notable to the extent to which its provisions require that parties act in good faith and use commercially reasonable procedures to produce commercially reasonable results. These standards provide safeguards to ensure that the results of close-out netting calculations are fair and objective as between the parties and based on the terms of the contract. To facilitate this result, Close-out Amount expands upon the scope of information that a determining party may take into account, including a requirement to consider certain external information or, in turn, to disregard such information where market conditions lead to commercially unreasonable results.

We have proposed another minor amendment to the draft language to reflect the distinction between entitlements and expectations. This is principally accomplished in our comments to the draft text by inserting "or costs" after the word "value" where applicable.

3) *Terminology*
The text of the draft law contains the terms "financial agreement"; "financial asset agreement" and "framework agreement." For both clarity and consistency, we would suggest using the term

"framework agreement" throughout. In turn, we would recommend defining "derivative transaction" instead of "financial transaction" (it being clear that many financial agreements and transactions, like loans and mortgages, are not covered by the bill).

In addition, we would also raise two substantive issues of high importance to the financial markets that you may want to consider.

4) *Collateral and title transfer arrangements*
The Statutory Memorandum clearly sets out the problems of recharacterisation and legal uncertainty that have made the development of a repo market in Israel more difficult. ISDA notes that these issues also seem potentially relevant to the title transfer arrangements widely used in the derivatives markets to reduce credit risk. 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).

Just as the draft law aims to facilitate the growth of a repo market by addressing the problems noted above, it may also be an excellent opportunity to eliminate the legal uncertainty as to the enforceability of title transfer arrangements under Israeli law. Recent legislation both in the United States (changes made to the Bankruptcy Code by Title IX of the Bankruptcy Abuse Prevention and Consumer Protection Act 2005) and the European Union (Directive 2002/47/EC on Financial Collateral Arrangements) highlight the close connection between sound legislation on the enforceability of close-out netting and collateral arrangements, particularly title transfer collateral arrangements. The financial markets have a growing interest in seeing effective protection for financial collateral arrangements put into place. It has been raised by foreign and Israeli market participants alike that improvements in legislation on close-out netting should go hand in hand with clarifications regarding financial collateral arrangements. With this possibility in mind, we have suggested language in the draft text which would extend the contemplated protections to these types of credit support arrangements.

ISDA would be glad to comment further on this particular issue, given the importance market participants currently attach to it, and, if it were thought that it would be helpful, to provide more detailed definitions and drafting suggestions where we have merely indicated that you may wish to consider further relevant changes.

5) *Eligible counterparties*
As we explained in our letter of 13 December 2004, ISDA members believe that netting legislation should be broad and flexible. If the benefits of netting are restricted to an "eligible counterparty", then ISDA recommends that the term should be broadly defined to include all potential beneficiaries of close-out netting legislation, including those outside the financial sector. Furthermore, ISDA recommends that netting arrangements, and the protections they provide, should not be "off-limits" to corporations, insurance companies, special purpose vehicles, wealthy and sophisticated individuals or others that could potentially benefit from close-out netting of OTC derivatives transactions entered into on a bilateral basis.

While in the past some netting legislation has drawn distinctions among the types of parties (for example, financial institutions) eligible for the benefits of close-out netting, it is not clear as a

matter of logic that such distinctions ought to exist. Such distinctions, by limiting the benefit, limit the legal certainty and the efficiencies that netting aims to achieve. Legislating for netting in this way often leads to a need for amendment to ensure the intended protections for a dynamic market. Invariably, such distinctions lead to difficult issues of characterization. As demonstrated by recent US legislative reforms, restricting the class of eligible counterparties will likely lead to a need to amend legislation to reflect the way business is conducted in what is a very dynamic marketplace.

In light of these general comments, we note that the draft text would limit the protections provided by netting legislation to trading intermediated by a financial institution, and then only when its counterparty is a corporate. This restriction may give rise to concerns in the wider marketplace, particularly in relation to questions as to the eligibility of foreign banks or financial institutions, or, in some cases, special purpose vehicles created for the purpose of a derivative transaction. Exercising control over which parties participate in these markets in Israel may be more a matter for regulation or licensing than for netting legislation. For your reference, please find attached wording from the aforementioned amendments to the US Bankruptcy Code which provides a definition of “financial participant” based on size.

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In conclusion, we would like to reiterate our belief that the draft language we have reviewed represents a sophisticated and intelligent approach to writing a technical and complex piece of legislation. In particular, we applaud your efforts to ensure that netting will be enforceable 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. Based on our review, we believe the draft law will be able to provide this assurance.

Our comments in this overview do not provide detailed explanation with regard to every suggested amendment we have made to the draft language in the attached document. Nonetheless, we believe that the bulk of our suggested revisions correspond to the general themes and technical distinctions outlined above.

We hope that our comments are helpful to you during your considerations. We remain ready, as the legislative process progresses, to work more closely with you to address in greater detail any of those issues we have identified or any which may arise going forward. Please do not hesitate to contact us with questions in response to these comments or to seek our technical support on these matters. We look forward to hearing from you again.

Sincerely,

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