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BY FAX AND BY POST

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People's Bank of China
32 Chengfang Street
Xicheng District, Beijing 100800
P.R. China

Attention: Mr. Li Bo

Dear Sir,

China Inter-bank Market Financial Derivatives Master Agreement (2007 Version) ("NAFMII Agreement")

First and foremost, the International Swaps and Derivatives Association, Inc. ("**ISDA**") would like to convey its most sincere gratitude to you and your colleagues for arranging and attending the meeting of ISDA representatives with Madam Wu Xiaoling on 9 January 2008. ISDA is extremely encouraged to see the determination of the People's Bank of China ("**PBOC**") to develop a healthy and sustainable financial derivatives market in China and the support it has given, and it is ISDA's sincere hope that it can join forces with regulators, industry associations, and market participants, to develop a sound and internationally competitive risk management framework in the market and to promote its healthy growth.

In addition, ISDA would like to take this opportunity to congratulate PBOC and the National Association of Financial Market Institutional Investors ("**NAFMII**") again on the successful publication of the NAFMII Agreement. The NAFMII Agreement comes at a time when the over-the-counter ("**OTC**") derivatives market in China is witnessing unprecedented growth, and where there is increasingly a market-wide desire to launch a unified document to effectively manage the increasing transaction risks arising from the growth in market size and a proliferation of products. The publication of the NAFMII Agreement thus provides an invaluable service to market participants and is an important milestone in the history of the Chinese derivatives market. In this regard, ISDA is very pleased to see that the NAFMII Agreement contains what are hailed as the "three pillars" of derivatives documentation for risk management purposes, namely, the concepts of "single agreement", "flawed asset" and "close-out netting". As you are aware, these three pillars are also core concepts in ISDA's documentation for cross-border derivative transactions, and the inclusion of these concepts in the NAFMII Agreement will definitely help pave the way for the wider reception of these concepts in the Chinese financial markets and in turn promote the healthy growth of the market.

ISDA is also very pleased that it had a most fruitful meeting with Mr Feng Guanghua and his colleagues from NAFMII to discuss the various opportunities for ISDA to work together with NAFMII for the mutual benefits of our members. We have also discussed certain issues relating to the NAFMII Agreement that, when properly addressed, will further boost market participants' confidence in and enthusiasm for adopting the NAFMII Agreement to document their derivative transactions in China. ISDA is honoured to have been requested by PBOC to provide a submission on those issues, and respectfully sets out in detail the relevant analysis for the kind consideration of PBOC and NAFMII.

Overlap with CFETS Agreement

Under Section 3(II) of the NAFMII Agreement, any Financial Derivative Transaction to be entered into between the parties is required to be governed by the NAFMII Agreement. The term "**Financial Derivative Transaction**" (the scope of which cannot be amended by the parties) is defined broadly and includes interest rate derivative transactions, bond derivative transactions, currency derivative transactions and credit derivative transactions.

However, this may create a potential overlap with another master agreement currently in use in the market. As you are aware, Renminbi-foreign exchange forwards and Renminbi-foreign exchange swap transactions between financial institutions in the PRC ("**CFETS Transactions**") and conducted on the China Foreign Exchange Trading System ("**CFETS**") are required under CFETS' trading rules to be governed by the Master Agreement for RMB-FX Derivative Products on the National Interbank Foreign Exchange Market (the "**CFETS Agreement**"). If two parties who have signed the CFETS Agreement (which is very likely to be the case because CFETS has required its members to sign the CFETS Agreement before 31 December 2007) also enter into the NAFMII Agreement, any currency derivative transactions (such as Renminbi-foreign exchange forward or swap) between them will potentially be governed by both the CFETS Agreement and the NAFMII Agreement. This could bring about legal and documentation risks to these market participants, because if an event occurs in relation to a party that may give rise to an action under one master agreement but not under the other, there is likely to be confusion as to what rights the parties have under each agreement and what action they may take. Even if a similar action happens to be triggered under both agreements, the rights and remedies available to a party may still be different with the result that the consequence of a particular event or action may become uncertain and open to argument.

The concept of "master agreement" itself indicates that it is designed to cover all derivative transactions. As such, ISDA agrees with PBOC and NAFMII that the best solution to this issue is to merge the two existing master agreements into one single agreement that governs all financial derivative transactions in China. However, ISDA understands that it may take time for the two agreements to be merged, and until then, some interim measures, such as devising bridging provisions to eliminate such legal and documentation risks may be adopted. Broadly speaking, the bridging provisions will allow both the NAFMII Agreement and the CFETS Agreement to apply to the CFETS Transactions but will also harmonise any mismatches and differing standards. The drafting of the bridging provisions can be very technical and depends on the degree of harmonisation to be achieved. In essence, the bridging provisions involve ensuring that the credit events under one master agreement trigger a credit event under the other master agreement (and vice versa) so that there is, in effect, one uniform set of credit events. Thereafter, the end product of the calculation of the early termination amount for CFETS Transactions under the CFETS Agreement can be included in the calculation of the early termination amount under the NAFMII Agreement. In addition, any other duplicated provisions can be similarly minimised or harmonised. The core provisions of the NAFMII Agreement and the CFETS Agreement are the single agreement and close-out netting provisions – through appropriately drafted bridging provisions these concepts will be further enhanced. In this regard, ISDA has extensive experience in devising bridging provisions that have been used in connection with many master agreements widely used in the international market and would be delighted to work with PBOC and NAFMII to produce appropriate bridging provisions for the market. To this end, ISDA will be contacting NAFMII and the State Administration of Foreign Exchange (the "**SAFE**") with a view to come up with an appropriate bridging provisions.

Scope of Financial Derivative Transactions

The term "Financial Derivative Transaction" is defined under Section 1 of the NAFMII Agreement as being financial derivative transactions concluded between the parties on a one-on-one basis. There is some confusion among market participants as to whether this term covers embedded derivative products, such as structured notes and structured deposits, as those transactions may also be structured on a one-to-one basis. This is particularly the case given that, when defining "credit derivatives", which is a type of Financial Derivative Transaction, the relevant Product Definitions expressly include credit-linked notes.

In the case of embedded derivatives (such as a structured note or a structured deposit) where a derivative is embedded into another asset (i.e. a note or deposit), market convention is to have the product documented in the form of the asset (being the note or the deposit and to have the derivative element written into such note or deposit itself). As such, a structured note is usually documented under a bank's note program and note subscription documents, and a structured deposit is usually evidenced by a deposit agreement, and not an OTC derivative agreement such as NAFMII Agreement or ISDA master agreement. This is also consistent with the characteristics and profile of an embedded derivative. For example, under a structured note, the noteholder pays up all money due from it upfront, and there are no ongoing obligations on its part to be performed (in contrast to an OTC transaction envisioned by the NAFMII Agreement where the obligations of both parties are contingent and continuing throughout the term of the agreement). Consequently, if the noteholder commits an event of default under Section 7(IX) of the NAFMII Agreement, the note should not be terminated since the note issuer is not taking any credit risk on the noteholder.

ISDA believes that the definition in Section 1 of the NAFMII Agreement can be effectively interpreted as only covering OTC transactions apart for the definition adopted in relation to credit derivatives. Therefore, instead of attempting to re-write this definition, a practical approach to clarify this point is through further explanation of the scope of Financial Derivative

Transactions in a user's guide (or a similar publication of this nature), and revising the Product Definitions so that the definition of "credit derivatives" only covers OTC transactions.

Use with non-members

At present, NAFMII has only organised its members to execute the NAFMII Agreement. ISDA understands that some members have raised the question whether they may execute the NAFMII Agreement with a person who is not a NAFMII member, to document any derivative transactions between them. This is particularly important to banks who usually enter into OTC derivative transactions in the inter-bank market on behalf of its clients since it is imperative that their client-facing documentation be consistent with the NAFMII Agreement, and that there be no basis risk between their client documentation and the NAFMII Agreement.

ISDA respectfully submits that for better risk management practice in derivative transactions and for the healthy growth of the derivatives market in China, NAFMII members should be given the option to use the NAFMII Agreement with non-members. The NAFMII Agreement is indeed published in response to the market's demand for a set of standard and unified derivative documentation, which would lower transaction costs and negotiation time, and stimulate financial innovation. If the NAFMII Agreement cannot be used as a client documentation, it may have the unintended effect of forcing the members to adopt their own derivative documentation for use with non-members. The existence of a plethora of derivative documentation may in turn encroach on the market standard intended to set by the NAFMII Agreement, increase transaction costs and time that could have been saved by adopting a standard agreement. More importantly, this may create additional risks, such as the basis risk between such client documentation and the NAFMII Agreement, and in the worst case scenario, to the extent a member fails to incorporate the risk management concepts embodied in the NAFMII Agreement in its client documentation, increase systematic risks. The heightened concern over client documentation may even stifle financial innovations as such innovations are usually driven by client needs. To this end, ISDA notes that there are suggestions that the NAFMII Agreement may be used by any two parties who wish to better manage the risks in the derivative transactions between them without the need for any of them to be NAFMII members. This is indeed the approach adopted by ISDA towards the use of the ISDA Master Agreements by market participants: even non-members may sign and document their derivative transactions under an ISDA Master Agreement. ISDA appreciates that, from a regulatory perspective, only financial institutions duly approved to engage in a derivatives business may offer derivative products or services to clients, and accordingly the use of the NAFMII Agreement will in effect be between one duly approved financial institution and another, or between such a financial institution and a client in China.

ISDA respectfully submits that NAFMII members be given the option to use the NAFMII Agreement with a non-NAFMII member on a bilateral basis.

Tax treatment of collateral transferred under "title transfer" arrangement

Some members have asked the question as to how the collateral transferred under title transfer arrangement contemplated in the Collateral Annex to the NAFMII Agreement should be treated for taxation purposes. Two issues potentially arise here.

First, a question arises as to whether stamp duty is payable in respect of the transfer of collateral and the re-transfer of equivalent collateral effected under such title transfer arrangement. The concern is that if the absolute transfer of bond securities will attract stamp duty, the transfer of collateral and re-transfer of equivalent collateral (being absolute transfers) may also attract stamp duty. Given that transfers will be accompanied by re-transfers under title transfer arrangements and that such transfers are for collateral purposes only, members have suggested that stamp duty should not be payable for transfers and re-transfers of collateral under title transfer arrangements. To this end, ISDA notes that a tax exemption is commonly given under the tax regulations of a number of jurisdictions. In this regard, the stamp duty treatment of title transfer arrangements should be similar to transfers and re-transfers made pursuant to repurchase transactions as well as bond lending and borrowing transactions in the inter-bank markets in China. ISDA understands that no stamp duty is payable in respect of repurchase transactions and bond lending transactions involving bonds in the inter-bank market and accordingly title transfer arrangements involving such bonds should be treated similarly. ISDA understands that if equity shares are to be given as collateral under title transfer arrangements, stamp duty should also not be payable for the same reason.

Secondly, a question arises as to whether income accrued on the collateral transferred under title transfer arrangements should be treated in the same way for income tax purposes as income accrued on collateral transferred pursuant to pledge arrangements. Under a pledge arrangement, ISDA understands that the collateral still belongs to the pledgor and hence any income on the pledged collateral will be taxable in respect of the pledgor. It would appear that since there is an absolute transfer under title transfer arrangements, the transferee becomes the absolute owner of the collateral assets with the consequence that any income accrued on the collateral will be taxable to the transferee. ISDA further understands that it is a matter of commercial contract between the parties to the NAFMII Agreement to the extent that they agree to allocate this income tax between them in any way. It will provide a great service to the market if PBOC or NAFMII could liaise with the tax bureau to have it produce a clarification to this effect .

Conclusion

ISDA fully supports the publication of the NAFMII Agreement which marked yet another significant milestone in the development of a risk management framework and practice in China. ISDA is also grateful for the opportunity to offer some preliminary insights as to possible ways to address the issues arising from the NAMFII Agreement that are of interest to market participants. ISDA would like to continue its discussions and co-operation with PBOC and NAFMII in relation to any further development in this regard. ISDA is committed to its members and to the development and growth of the derivatives market in China and to this end ISDA would be happy to draw on its and its members' resources and experience to contribute towards the development of a sound and internationally competitive risk management practice in China.

If you or your colleagues have any questions, please do not hesitate to contact Keith Noyes in Hong Kong on (852) 2801 7630; Bay Way Yee in Singapore on (65) 6532 3870 or Chin-Chong Liew of Linklaters on (852) 2842 4857 or to send a fax to us at the above number.

Yours faithfully,
For the International Swaps and Derivatives Association, Inc.

Keith S. Noyes

Keith Noyes
Regional Director

Bay Way Yee
Policy Director

c.c. **Madam Wu Xiaoling**
The People's Bank of China

Mr Feng Guanghua
National Association of Financial Market Institutional Investors