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Ms Davida Lachman-Messer, Adv.
Deputy Attorney General
Economic & Fiscal Matters
Ministry of Justice
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ISRAEL

Cc: Ms Dalit Zamir

Dear Ms Lachman-Messer,

Proposed netting legislation in Israel – ISDA technical comments

As you know, the International Swaps and Derivatives Association, Inc. ("**ISDA**") is an international financial trade association whose membership comprises over 670 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 (50 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. We also refer to our fax to you of 28 July 2005 in which we provided some technical comments on a draft of the Proposed Financial Assets Agreement Law (the "**Proposed Law**") and we indicated our strong support for the Proposed Law.

We have since been provided with an English translation of a revised draft of the Proposed Law. We understand that this translation is unofficial, and we attach a copy of it to this letter so that you can assess our comments against the translation we have used. We acknowledge that some of our points may simply reflect translation, rather than substantive issues, and therefore may not be relevant when considered in the context of the official Hebrew language version of the Proposed Law. We apologise in advance for our reliance on the unofficial English translation,

but we hope that you will nonetheless find our comments, and the underlying principles they are intended to reflect, to be helpful.

We would like to re-emphasise our strong support for the Proposed Law. The Proposed Law is an important piece of legislation that, when enacted, will bring significant benefits to the State of Israel, its financial market and its banks, corporations and other financial market participants. We note that the latest draft of the Proposed Law includes provisions strengthening the validity and enforceability of title transfer collateral arrangements (referred to as "interim accounting" in the attached draft or "interim settlement arrangement" in another unofficial translation we have seen). Subject to one comment below concerning the scope of these provisions, we believe that these provisions strengthen the Proposed Law, and we strongly support them.

1. "**Framework agreement**" – **required provisions**. In order to qualify as a "framework agreement", the Proposed Law requires an agreement to include all the provisions set forth in sub-sections (1) to (4) of the definition of "early termination provisions". We would suggest that sub-sections (2) to (5) should be included, rather than sub-sections (1) to (4).

   It is certainly the case that many market master agreements, and in particular those published by ISDA, constitute a single agreement between the parties governing all transactions entered into between the parties under that master agreement.

   But parties may wish to reduce further any credit risk arising between them by use of a type of agreement that is commonly referred to in the market by various names, including "cross-product netting agreement", "bridge agreement", "master master agreement", "umbrella master agreement" or "cross-product master agreement" (in any such case, a "**Cross-Product Netting Agreement**"). There are various examples of market standard versions of such agreements, including ISDA's 2001 Cross Agreement Bridge and its 2002 Energy Agreement Bridge, as well as the Cross-Product Master Agreement (version 1), published by The Bond Market Association with our endorsement.

   A Cross-Product Netting Agreement relating to two or more master agreements has two principal effects. First, an event of default under one master agreement, resulting in early termination of the transactions under that master agreement, permits the early termination of all transactions under the other master agreements. Secondly, the Cross-Product Netting Agreement nets out the close-out amounts due under each master agreement to produce a single "net net" balance. A Cross-Product Netting Agreement might therefore be used to bridge and cross-net close-out amounts due between two parties under an ISDA Master Agreement, a Global Master Repurchase Agreement and one or more of various single-product master agreements used in the energy sector.

   Cross-product netting has recently been the focus of supervisory attention in the context of the implementation of the Basel II Capital Accord. Banking supervisors recently confirmed, after some discussions with industry, that cross-product netting would be eligible for recognition for purposes of regulatory capital relief under the new Capital Accord subject to the same legal opinion and related rules currently required for

recognition of close-out netting under a "single agreement" master agreement, such as the ISDA Master Agreement.

Regarding sub-section (5) of the definition of "framework agreement", we would suggest including it "where appropriate" (that is, where transactions may be entered into under the relevant master agreement in more than one currency) as it is essential to any netting arrangement involving more than one currency that close-out values all be converted to a single currency in order to determine a single net amount due.

2. "**Framework agreement**" – **required parties**. Is it the intention of the Proposed Law that each party to an agreement is required to be a corporation (that is, a company) in order for the agreement to qualify as a framework agreement, or simply that each party must be a non-natural person? We note that, while the definition of "financial institution" includes many types of entity which may not be corporations, the unofficial translation of the Proposed Law which we have reviewed refers to "corporations" in the definition of "framework agreement" and in certain other provisions.

   We do not see a reason for restricting the scope of the Proposed Law to agreements between corporations, as many market participants operate in other forms, including partnerships (general and limited), trustees for investment and other trusts, international organisations, foreign central banks, foreign sovereigns (directly or through a branch of government or autonomous agency) and so on.

   To the extent that the current draft of the Proposed Law includes this restriction, we would therefore suggest replacing it with a requirement that the agreement simply be between non-natural persons (that is, legal persons who are not private individuals).

   On a slightly different point, we note your current requirement that at least one of the parties be a financial institution or the State of Israel. The netting legislation in a number of other countries does not include such a requirement, and the absence of such a requirement does not appear to have caused any difficulties in those markets. At the same time, the absence of the requirement means that the protections of the netting legislation are available in a broader range of circumstances, which is beneficial in terms of strengthening the integrity of the whole market.

3. "**Interim accounting**" - **scope**. As noted above, in the unofficial translation we have reviewed, the term "interim accounting" appears to cover what we would describe as a title transfer collateral arrangement. We strongly support this addition to the Proposed Law as this is an important form of financial collateral arrangement.

   We note, however, that the scope of the provision in the current Proposed Law is limited to arrangements involving the delivery of securities. Cash collateral is not covered. We understand that this may be because of a view you have taken that there is no risk of recharacterisation of a transfer of cash collateral transfer under a title transfer collateral arrangement as constituting a form of secured loan.

As a trade association, we defer to national legal experts in Israel as to whether a cash collateral transfer could be recharacterised as some form of security interest, but we note that cash collateral is a very important type of financial collateral, and the markets would draw a significant amount of reassurance from the express inclusion of cash collateral in the "interim accounting" provision, even if it is not strictly necessary in your view.

We note, for example, that the European Financial Collateral Arrangements Directive expressly refers to cash as well as securities title transfer collateral arrangements, as do a number of other national and international instruments dealing with financial collateral. We believe that the inclusion of cash in this provision would further strengthen market confidence.

4. "**Underlying asset**". One of the most important aspects of the Proposed Law is, of course, its scope. As currently drafted, the Proposed Law applies only to derivative transactions in respect of a restricted list of underlying assets.

We would suggest expanding this list to cover other types of asset or other measures of economic value that are currently the subject of derivative transactions, for example credit risk, inflation, emissions allowances, weather and freight. ISDA would be glad to provide a more comprehensive list of the types of asset or measure of economic value that are frequently the subject of derivative transactions. We can also refer you in this regard to the 2002 Model Netting Act which we sponsor and is available from our website (we will shortly be publishing a revised version of the Model Netting Act, but you may still find the 2002 version to be helpful in this regard). We would strongly recommend that you expand the list of "underlying assets" to encompass such assets and other measures of economic value.

In addition, as the financial markets are subject to continuing change, innovation and development, we would suggest including a provision in the Proposed Law, comparable to sub-clause (8) of the definition of "financial institution" in the attached unofficial translation, which would grant the Minister of Finance authority to expand, by appropriate order or secondary legislation, the list of underlying assets to include additional types of asset and other measures of economic value.

5. "**Derivative transaction**". We note that you have removed the requirement that the Minster of Justice approve a type of transaction in order for it to constitute a "derivative transaction". We consider this to be an important improvement and strongly support this change.

The definition of "derivative transaction" in the unofficial translation we have reviewed refers to a "transaction derived from an underlying asset". We would suggest that a more accurate definition would be that a derivative transaction is a transaction whose value is derived from the value of an underlying asset trading in an underlying market or from fluctuations in a measure of economic value (such as, in the case of inflation derivatives, the retail price index). The generic wording at the end of the definition of "qualified financial contract" in the 2002 Model Netting Act may be of assistance in this regard.

6. "**Securities repurchase transaction**". We note that the definition of "securities repurchase transaction" in the unofficial translation we have reviewed refers to the transfer by the transferee of securities to the transferor "at the end of a pre-agreed period". Repos are often entered into in the financial markets for an indefinite period, where securities are deliverable "on demand". We would therefore suggest adding the words "or on demand" after the words "a pre-agreed period" in this definition.

7. "**Security**". We note that the definition of "security" in the unofficial translation we have reviewed refers in sub-clauses (1) and (2) to certificates. We note that there is an additional sub-clause (3) that refers to "a security as defined in the Companies Law, as determined by the Minister of Finance in an order". As many securities are issued in registered or dematerialised, where no physical certificate is provided, would sub-clause (3) be broad enough to cover such securities? Also, most (virtually all) securities delivered as financial collateral are transferred by book entry within securities settlement systems or on securities accounts maintained by financial custodians.

   Would securities transferred and held in this way be firmly within the definition of "security" in the Proposed Law? If not, its utility will be substantially diminished.

8. "**Waiver" of onerous asset**. We refer to Section 3 of the Proposed Law, which is entitled "Waiver of Onerous Asset" in the unofficial translation we have reviewed (we presume that, rather than "waiver", this should say "disclaimer" or "repudiation" in English, and we assume that the Hebrew language version would have this latter significance).

   We welcome the addition of this provision, which clarifies that a liquidator's power to disclaim contracts cannot be used to defeat close-out netting effected under a framework agreement.

   We note that the Proposed Law clarifies that this does not prevent a framework agreement as a whole being disclaimed under this power. We do not believe this is a problem, provided that it is clear that (a) where the framework agreement has been disclaimed as a whole, a solvent party is able to prove in the relevant insolvency proceedings for the full amount of its net claim under the close-out provisions of the framework agreement and (b) a power of disclaimer would not interfere with the solvent party's ability to enforce any collateral it had taken in relation to its net exposure under the framework agreement.

   It may be that the foregoing would be clear when read in the light of relevant provisions of Israeli insolvency law relating to disclaimer of contracts, but if this could be clarified in the Proposed Law, that would be helpful to international financial market participants.

9. "**Insolvency proceedings**". We assume that the definition of "insolvency proceedings" in the Proposed Law includes all types of insolvency proceeding to which an Israeli bank or company might be subject, including any form of reorganisation or rehabilitation

statute that might exist. We mention this only because we noted in the unofficial translation the reference to "liquidation" and "receivership" but no express mention of a "reorganisation" or "rehabilitation" type proceeding. Would section 350 of the Companies Law contemplate that sort of proceeding?

10. **Explanatory notes**. The Explanatory Notes to the Proposed Law are very helpful. We note that the "General" explanatory comment refers to the importance of ensuring the enforceability of a framework agreement. We would suggest expanding this to cover, in addition to the enforceability of the framework agreement in general, the enforceability of the early termination provisions in particular. In other words, it would be helpful to draw a specific connection between the enforceability of the framework agreement and the specific enforceability of close-out netting under Israeli law.

    The explanatory notes also refer to an example of a master agreement for securities repurchase (repo) transactions, namely the "ISMA Global Master Repo Agreement". We note that this agreement is co-published by two organisations, both of which have changed their names in recent years. We would suggest amending this reference so that it reads as follows: "the Global Master Repurchase Agreement, after the name of the international organisations that drafted it (the International Capital Markets Association, formerly the International Securities Markets Association, and The Bond Markets Association, formerly the Public Securities Association)".

In conclusion, we would like to reiterate our view that the Proposed Law will, when enacted, considerably strengthen the legal framework for financial trading in Israel, boosting the confidence of international financial market participants when dealing with Israeli counterparties and reinforcing the efficiency and integrity of the Israeli financial markets. In particular, we applaud your efforts to ensure that netting and title transfer collateral arrangements will be enforceable in accordance with the terms of the parties' agreement. It is clearly important to ISDA's members that they are able to rely with confidence on their agreements being enforceable in accordance with the terms that they have expressly agreed. Based on our review of the attached unofficial translation of the Proposed Law, we continue to believe that the Proposed Law will be able to provide this assurance.

We hope that you will find these comments and suggestions helpful. Should you require any further information or wish to discuss any of these issues in more detail with us, please do not hesitate to contact Peter Werner in London on +44 20 7330 3553.

Yours faithfully,

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