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По факсу та електронній пошті

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Щодо забезпечення правової визначеності у сфері транзакцій з деривативами в Україні

Шановний пане Азаров!

Члени Міжнародної Асоціації Свопів та Деривативів (МАСД) в Україні та за її межами привернули нашу увагу до зусиль Вашого Комітету та Верховної Ради, спрямованих на вдосконалення законодавчої та нормативно-правової бази у сфері транзакцій з деривативами в Україні, і ми хотіли б висловити нашу підтримку Вашого інтересу до цієї діяльності.

МАСД – це світова торговельна асоціація, яка представляє провідних учасників у галузі деривативів, що торгуються у приватному порядку. Такі деривативи або похідні фінансові інструменти включають процентні, валютні, товарні, кредитні свопи, свопи акцій, опціони та форварди, а також такі пов'язані продукти, як кепи, коллари, флори та свопціони. У Додатку А до цього листа вказані деривативи, транзакції з якими відбуваються найчастіше з використанням документації МАСД. МАСД наразі має понад 825 членів з 57 країн на п'яти континентах. Більше половини загальної кількості членів знаходяться в Європейському Союзі та сусідніх країнах, а значна частина решти членів – це учасники, які активно діють на європейських фінансових ринках в якості дилерів, провайдерів послуг або кінцевих користувачів деривативів. Одним з головних завдань МАСД з моменту її створення у 1985 р. є підвищення правової визначеності міжнародних фінансових транзакцій шляхом здійснення правової реформи.

МАСД активно сприяє розвитку ефективних практик управління ризиками. Її діяльність включає у себе зусилля, спрямовані на створення належного правового та регуляторного середовища для здійснення позабіржових транзакцій з деривативами. Учасники ринку та ключові регулюючі органи розглядають МАСД в якості відповідальної організації, яка робить значний внесок в обговорення підходів до найкращого управління ризиками, що супроводжують позабіржові транзакції з деривативами. Зокрема, МАСД працює з регулюючими органами в різних юрисдикціях світу над забезпеченням правових можливостей для

застосування механізму ліквідаційного неттингу відповідно до Генеральної угоди МАСД, яка є провідним стандартним документом для міжнародних позабіржових транзакцій з деривативами в усьому світі¹.

З причин, які викладені нижче, члени Комітету Центральної та Східної Європи МАСД особливо зацікавлені у тому, щоб надати усю можливу допомогу та співпрацювати з Вашим Комітетом та іншими компетентними органами в Україні з метою забезпечення правової бази для позабіржової торгівлі деривативами, правових можливостей застосування Генеральної угоди МАСД та, зокрема, ліквідаційного неттингу в Україні, що сприятиме подальшій гармонізації з міжнародними стандартами.

Що таке ліквідаційний неттинг?

Більшість документів, які широко використовуються на міжнародних ринках фінансових деривативів, складаються у формі генеральної або рамкової угоди. Усі ці генеральні угоди функціонують як генеральні угоди з неттингу, відповідно до яких сторони можуть брати участь у ряді різних транзакцій і в разі припинення торгівлі через ліквідацію або інші події можуть розрахувати чистий загальне сальдо усіх цих транзакцій для кожної сторони.

Ліквідаційний неттинг у позабіржових транзакціях з деривативами – це можливість для сторони генеральної угоди, що регулює такі транзакції (наприклад, Генеральної угоди МАСД) розрахувати ринкову вартість усіх існуючих транзакцій відповідно до генеральної угоди при їх достроковому припиненні у разі дефолту іншої сторони або настання інших визначених подій. Конкретний приклад того, як можна зменшити ризики та витрати за допомогою ліквідаційного неттингу, наведений у Додатку В.

Переваги ліквідаційного неттингу

Перевагами ліквідаційного неттингу є зменшення ризиків та витрат. Ліквідаційний неттинг дозволяє зменшити ризики на двох рівнях – зменшити кредитні ризики і, як наслідок, системні ризики. Він зменшує кредитний ризик окремих сторін, оскільки зменшує їх загальний потенційний ризик у відносинах з іншими сторонами на більш ніж 85 відсотків². Зменшуючи кредитний ризик у кожному вузлі мережі відносин між учасниками ринку, ліквідаційний неттинг також створює важливий позитивний вплив на системний ризик.

Визнаючи важливість ліквідаційного неттингу, центральні банки країн «Великої десятки» та центральні банки інших юрисдикцій дозволили визнання неттингу для цілей забезпечення адекватності капіталу та управління значними потенційними ризиками за умови виконання пруденційних вимог. Інші переваги ліквідаційного неттингу для учасників ринку включають більш ефективне використання кредитних ліній та можливість виділення менших резервів для покриття потенційних ризиків.

Потреба у правовій визначеності та законодавстві для регулювання неттингу в Україні

Хоча в Україні немає законів або нормативно-правових актів, які б в явній формі вказували, що ліквідаційний неттинг не може бути застосований, багато учасників ринку та експертів з права вважають, що в українському законодавстві не сформульована чітка позиція з цього питання. За відсутності конкретних положень у законодавстві України українські суди можуть заборонити застосування ліквідаційного неттингу у випадку неплатоспроможності – наприклад, якщо місцеві політичні інтереси будуть переважати над рішенням сторін обрати певне законодавство в якості законодавства, яке регулюватиме їх контракт. Тому наш Комітет Центральної та Східної Європи глибоко переконаний у необхідності забезпечення правової визначеності та правової реформи на ринку деривативів в Україні. Отже, одне з головних призначень цього листа – ініціювати діалог щодо можливості застосування в Україні найважливіших положень Генеральної угоди МАСД, які стосуються ліквідаційного неттингу. Визнаючи суттєві кредитні та системні переваги ліквідаційного неттингу, багато юрисдикцій, в яких раніше були певні сумніви щодо можливостей застосування неттингу, прийняли законодавство для їх забезпечення або – і це

¹ МАСД опублікувала п'ять форм Генеральної угоди МАСД: (i) Угода про процентні свопи МАСД 1987 р.; (ii) Угода про процентні і валютні свопи 1987 р.; (iii) Генеральна угода МАСД 1992 р. (місцева валюта – одна юрисдикція); (iv) Генеральна угода МАСД 1992 р. (більше однієї валюти – міжнародні транзакції); та (v) Генеральна угода МАСД 2002 р.

² Банк міжнародних розрахунків (Bank for International Settlements), Травень 2009

відбувалося частіше – для зміцнення таких можливостей там, де вони вже існували. Приклади в Європі включають Австрію, Бельгію, Чехію, Данію, Фінляндію, Францію, Німеччину, Грецію, Угорщину, Ірландію, Італію, Люксембург, Мальту, Норвегію, Польщу, Португалію, Румунію, Словаччину, Іспанію, Швецію, Швейцарію та Туреччину. Приклади в інших частинах світу включають Австралію, Бразилію, Канаду, Ізраїль, Японію, Маврикій, Мексику, Нову Зеландію, Південну Африку, Південну Корею та Сполучені Штати. Звіт про поточні можливості застосування ліквідаційного неттингу у різних країнах світу наведений у Додатку С.

Як вже було зазначено, провідні члени МАСД за межами країни хотіли б бачити Україну у списку юрисдикцій, в яких були здійснені необхідні законодавчі реформи на підтримку міжнародних стандартів у зв'язку із загальною невизначеністю правового статусу ліквідаційного неттингу в Україні. Як ми розуміємо, інтерес цих членів відображає поточні ініціативи в Україні, спрямовані на покращення правової визначеності та позиції України на фінансових ринках світу.

Важливі фактори, які необхідно врахувати у законодавстві, що регулюватиме ліквідаційний неттинг

Що мають включати у себе мінімальні стандарти законодавства про ліквідаційний неттинг? Відповідно до того, що обговорювалося вище, для МАСД у підтримці прийняття законодавства про ліквідаційний неттинг найважливішими є два питання: (1) забезпечення можливості застосування неттингу, тобто проведення неттингу відповідно до закону та умов, узгоджених між сторонами, особливо якщо ці умови відображають світовий стандарт у цій галузі, та (2) технічні відмінності між неттингом та взаємозаліком, які необхідно враховувати. Обидві ці теми відображені у Типовому законі про неттинг МАСД, який наводиться у Додатку D. Звичайно, слід вказати на те, що цей Типовий закон про неттинг не призначається для запозичення та прийняття у повному обсязі. Він скоріше являє собою перелік важливих моментів, на які слід звернути увагу при аналізі конкретних обставин та розробці законодавства в Україні.

Проект Закону України "Про похідні (деривативи)"

Ми нещодавно ознайомилися з англійською версією проекту Закону України "Про похідні (деривативи)". Ми усвідомлюємо, що за цей час текст цього проекту закону міг змінитися, і що деякі наші зауваження до нього можуть впливати з нашого тлумачення англійського перекладу і не мають зв'язку з українською версією цього проекту. Ми просимо вибачення заздалегідь за те, що покладаємося на англійський переклад, та будь-які непорозуміння, що можуть бути цим спричинені.

Ми також поінформовані, що цей проект закону знаходиться на стадії попередньої підготовки і може підлягати подальшому обговоренню та змінам. Ми також розуміємо, що замість внесення змін до існуючого проекту закону може розглядатися зовсім інший підхід до створення цього законодавства. Звичайно, ми будемо раді надати наші зауваження з конкретних питань на відповідному етапі законодавчого процесу.

Утім, поки що ми хотіли б поділитися з Вами своїм занепокоєнням з приводу проекту Закону "Про похідні (деривативи)". Якщо цей закон буде прийнятий в його нинішній формі, він навряд чи досягне своєї мети, а саме створення ефективної законодавчої бази для транзакцій з деривативами в Україні та забезпечення визначеності для учасників ринку деривативів. Ми вважаємо, що наслідки можуть бути протилежними – цей закон може завадити появі життєздатного ринку деривативів та створити додаткові перепони для міжнародних інвесторів.

Вам також можуть видатися цікавими наші наступні зауваження більш загального характеру до того проекту закону, з яким ми ознайомилися:

1. Обсяг. МАСД вважає амбітною пропозицію щодо прийняття комплексного та самодостатнього закону про деривативи. Це також може бути ризикованим, якщо міжнародним учасникам відповідних ринків не будуть надані можливості та час для висловлення зауважень. В інших юрисдикціях у цілому застосовувався інший підхід – зазвичай з урахуванням складності ринку та технічних ускладнень з узгодженням та наданням детальних роз'яснень з усіх питань, які висвітлюються у проекті Закону України "Про похідні (деривативи)". Зокрема, може бути доцільним розгляд питання щодо того, якою мірою режим для біржових

деривативів повинен відрізнятись від режиму позабіржової торгівлі. Крім цього, бажано, щоб будь-яке визначення деривативів у законодавстві було достатньо ефективним для того, щоб також охопити подальші інновації на відповідних динамічних ринках без потреби у додатковому реформуванні законодавства. Проте якщо Верховна Рада вирішить застосувати запропонований підхід, який є більш комплексним, МАСД готова співпрацювати та надавати технічну допомогу у зв'язку з цією ініціативою, коли це буде можливим та доцільним.

2. Можливості правозастосування. Учасники ринку деривативів будуть почуватися набагато комфортніше, якщо у законодавстві буде чітко та однозначно встановлено, що в українських судах можна забезпечувати виконання умов транзакцій з деривативами відповідно до рамкових контрактів – таких, як Генеральні угоди МАСД. Учасникам ринку також потрібен законодавчий захист контрактів, які регулюються законодавством інших країн та складені на іншій мові.

3. Ліквідаційний неттинг. Як зазначено вище, для членів МАСД є важливим питання визнання неттингу та можливості його застосування відповідно до умов контрактів між сторонами. Ми не знайшли в існуючому проекті закону жодного положення, яке б забезпечувало таку можливість.

4. Забезпечення. Учасники ринку також дуже хотіли б побачити можливості для застосування додаткового забезпечення або маржових схем без ризику зміни категорії транзакції. Це є додатковим інструментом, за допомогою якого учасники ринку мінімізують у транзакціях з деривативами свої кредитні, а отже і системні ризики.

Економічні переваги та конкурентоспроможність

Внаслідок невизначеності на ринку деривативів в Україні фінансові установи та інституційні інвестори в Україні та за її межами, які здійснюють фінансові транзакції з українськими контрагентами, діють у несприятливих умовах конкуренції, оскільки не можуть впевнено розраховувати чисту позицію у транзакціях з деривативами, які вони здійснюють з українськими контрагентами, або покладатися на умови, визначені в їх контрактах. МАСД пропонує Уряду України свою допомогу у зменшенні ризиків будь-яких таких несприятливих умов та підвищенні правової визначеності для міжнародних учасників ринку, які вступають на фінансові ринки України. Економічні переваги такої реформи для України будуть значними, не в останню чергу завдяки тому, що місцеві контрагенти зможуть краще регулювати валютні та процентні невідповідності в їх балансових звітах. Ми впевнені, що ці заходи сприятимуть подальшому зміцненню та розвитку економіки України та позиції України на світових фінансових ринках.

Ми сподіваємося, що наші зауваження виявляться корисними для Вас у Вашій діяльності. МАСД повністю поділяє та підтримує підхід, який лежить в основі Ваших зусиль, спрямованих на створення надійної законодавчої бази та підвищення правової визначеності в Україні. Ми були б дуже раді можливості тісно співпрацювати з Вами у вирішенні визначених нами питань на відповідному етапі законодавчого процесу. Якщо МАСД може надати будь-яку допомогу у цьому процесі, ми сподіваємося, що Ви без вагань зв'яжетеся зі мною в європейському офісі МАСД: One Bishops Square, London E1 6AD, +44 20 3088 3550, pwerner@isda.org.

Як ми розуміємо, подібними питаннями спільно займається декілька українських установ. Отже, ми вирішили, що буде доцільно надіслати цей лист також до Міністерства фінансів України, Національного Банку України та Голові Державної Комісії з Цінних Паперів та Фондового Ринку України.

З повагою,

Д-р Пітер М. Вернер
Директор з питань політики
pwerner@isda.org



International Swaps and Derivatives Association, Inc.
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8 July 2009

Per fax and e-mail

Mykola Yanovych Azarov
Chairman of the Committee on Finance and Banking
5 Hrushevskoho Street
UA-01008 Kiev
Ukraine

Re: Achieving Legal Certainty for Derivatives in Ukraine

Dear Mr. Azarov,

Our attention has been drawn by members of the International Swaps and Derivatives Association, Inc. ("ISDA"), inside and outside of Ukraine to the efforts by your Committee and the Verkhovna Rada seeking to improve the legal and regulatory framework for derivatives transactions in Ukraine, and we write to applaud your interest in doing so.

ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry, a business that includes interest rate, currency, commodity, credit and equity swaps, options and forwards, as well as related products such as caps, collars, floors and swaptions. The most commonly entered into transactions under ISDA documentation are described in Appendix A to this letter. ISDA currently has more than 825 members from 57 countries on five continents. More than half of the total membership is based in the European Union and neighbouring countries and a significant portion of the rest comprises participants active in the European financial markets as dealers, service providers or end users of derivatives. Promoting legal certainty for cross-border financial transactions through law reform has been one of ISDA's core missions since it was chartered in 1985.

ISDA is committed to promoting the development of sound risk management practices. Its work includes efforts to ensure adequate legal and regulatory treatment of over-the-counter ("OTC") derivatives transactions. Market participants and key regulators view ISDA as a responsible contributor in the debate on how best to manage the risk associated with OTC derivatives transactions. In particular, ISDA has worked with regulators in jurisdictions around the world to promote the legal enforceability of the close-out netting mechanism in the ISDA Master Agreement, which is the leading standard form documentation for international OTC derivatives transactions worldwide³.

For reasons set forth below, members of ISDA's Central and Eastern Europe Committee are particularly eager to provide all possible assistance to and cooperate with your Committee and appropriate authorities in Ukraine in order

³ ISDA has published five forms of the ISDA Master Agreement: (i) the 1987 ISDA Interest Rate Swap Agreement; (ii) the 1987 ISDA Interest Rate and Currency Exchange Agreement; (iii) the 1992 ISDA Master Agreement (Local Currency – Single Jurisdiction); (iv) the 1992 ISDA Master Agreement (Multicurrency – Cross Border); and (v) the 2002 ISDA Master Agreement.

to facilitate statutory support for OTC derivatives, the legal enforceability of the ISDA Master Agreement and, in particular, close-out netting in Ukraine and thereby foster greater harmonization of international standards.

What is close-out netting?

Most documents that are widely used in international financial derivative markets are drafted as a type of master or framework agreement. Each of these master agreements is designed as a master netting agreement under which the parties can enter into a number of different trades and, on close-out, calculate the net exposure between the parties under all of these trades.

Close-out netting in relation to OTC derivative transactions is the ability of a party under a master agreement for such OTC derivative transactions (such as an ISDA Master Agreement) to net the mark-to-market values of all existing transactions under the master agreement upon their early termination following the default of its counterparty or other specified events. Appendix B provides a concrete example of how risks and costs may be reduced via close-out netting.

The benefits of close-out netting

The benefits of close-out netting are risk reduction and cost reduction. The risk reduction is twofold: reduction of credit risk and the consequent reduction of systemic risk. Credit risk reduction benefits an individual party by reducing its overall exposure to its counterparty by more than 85 percent⁴. By reducing credit risk at each node in the network of relationships between market participants, close-out netting also has an important beneficial effect on systemic risk.

Recognizing the value of close-out netting, the G10 central banks and central banks of other jurisdictions have permitted, subject to prudential conditions, the recognition of netting for capital adequacy and large exposure purposes. Other benefits for market participants include more efficient use of credit lines and the ability to maintain lower reserves to cover exposures.

The need for legal certainty and netting legislation in Ukraine

Although there are no laws or regulations in Ukraine explicitly stating that close-out netting would not be enforceable, many market participants and legal experts believe that Ukrainian law does not set out a clear position on this issue. Without specific guidance under Ukrainian law, a Ukrainian court might prevent the application of close-out netting in an insolvency proceeding, for example, where local policy interest might be seen as overriding the parties' choice of law for their contract. Indeed, our Central and Eastern Europe Committee has expressed their particular support for derivatives market legal certainty and law reform in Ukraine, and a primary purpose of this letter is to initiate a dialogue on the enforceability in Ukraine of critical provisions of the ISDA Master Agreement that relate to close-out netting. Recognizing the substantial credit and systemic benefits of close-out netting, many jurisdictions, where previously there was some doubt about the enforceability of netting, have introduced legislation to enable it or, more often, to strengthen it where it was already available. Examples in Europe include Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, Malta, Norway, Poland, Portugal, Romania, Slovakia, Spain, Sweden, Switzerland and Turkey. Examples elsewhere include Australia, Brazil, Canada, Israel, Japan, Mauritius, Mexico, New Zealand, South Africa, South Korea and the United States. A current status report on the enforceability of close-out netting worldwide is attached as Appendix C.

As indicated, leading ISDA members from outside the country would like to see Ukraine on this list of jurisdictions where relevant statutory reforms have been enacted in support of international standards in light of overall uncertainty about the legal status of close-out netting in Ukraine. We understand the interest of these members mirrors current initiatives in Ukraine for improving legal certainty and the standing of Ukraine's financial markets in the world.

⁴ Bank for International Settlements, May 2009

Important Factors To Consider in Close-Out Netting Legislation

What should the minimum standards of close-out netting legislation include? In accordance with the points discussed above, two central themes that ISDA has emphasised when advocating the adoption of close-out netting legislation are: (1) legal enforceability by ensuring that any statutorily supported netting occurs in accordance with the parties' agreed terms, especially where these reflect a global industry standard, and (2) technical distinctions that need to be considered when distinguishing netting from set-off. Both of these themes are reflected in ISDA's Model Netting Act, attached as Appendix D. Of course, it should be pointed out that the Model Netting Act is neither intended nor suitable for wholesale adoption, but is rather a catalogue of relevant issues for review as you consider and legislate for the particular circumstances in Ukraine.

Draft Law of Ukraine "On Derivatives"

We have recently seen an English language version of a draft text of Ukraine's Law "On Derivatives". We appreciate that the text may have since changed, and there may also be points reflected in any comments we might make about the proposed draft that arise from our reading of the translation but that may not be relevant when considered in the context of the Ukrainian language version of the draft. We apologise in advance for our reliance on the English translation and any confusion that may have resulted from it.

Moreover, we are informed that this draft proposal is at a preliminary stage and may be the subject of debate and amendment. We also understand that, rather than amendments to the current draft, consideration may be given to a very different approach to the legislation. We would, of course, be happy to provide comments on specific issues as the legislative process proceeds.

In the meantime, we would like to share with you our concern that the draft Law "On Derivatives", if adopted in its current form, would be highly unlikely to achieve its goal of creating an efficient legislative framework for derivatives transactions in Ukraine and providing certainty for derivatives market's participants. On the contrary, we believe it could hinder the creation of the viable derivatives market and create additional disincentives for international investors.

In addition, the following comments of a more general nature, based on the draft that we have seen, may be of interest:

1. **Scope.** ISDA views the proposal to adopt a comprehensive and self-contained law on derivatives as ambitious. Unless there is adequate opportunity and time for comment from the international marketplace, it may also be risky. The approach taken in other jurisdictions has generally been different – usually in recognition of the complexities of the marketplace and the technical difficulties with agreeing and providing the detail for all issues contemplated in the Draft Law of Ukraine "On Derivatives." In particular, you may wish to consider the extent to which the regime applicable to exchange traded derivatives should be distinguished from OTC trading and ensure that any definition of derivatives in the legislation is robust enough to accommodate, without the need for further statutory reform, future innovation in what are dynamic markets. If, nevertheless, the Verkhovna Rada elects to take this more comprehensive approach, then ISDA stands ready to co-operate and provide technical assistance where possible and appropriate in connection with that undertaking.
2. **Legal enforceability.** Derivatives market participants will take great comfort from a clear and unequivocal statutory recognition that derivatives trading under framework contracts, like ISDA's Master Agreements, will be enforceable by Ukrainian courts. Market participants will equally want statutory protection for contracts governed by foreign laws and language.
3. **Close-out netting.** As indicated above, a key issue, insofar as ISDA members are concerned, is that netting will be recognised and enforced in accordance with the terms of the parties' contract. We could not find a provision in the current Draft Law acknowledging this treatment.

4. Collateral. Market participants will also be keen to see the enforceability of ancillary collateral or margin arrangements recognised, without risk of re-characterisation. This is an additional means by which market participants minimise their credit risks on derivative transactions, and thus systemic risk.

Economic benefits and competitiveness

As a result of the uncertainty of the derivatives market in Ukraine, financial institutions and institutional investors inside and outside Ukraine that deal with Ukrainian counterparties in financial transactions are at a competitive disadvantage, because they cannot confidently net their derivatives exposures against their Ukrainian counterparties or rely on the terms set forth in their contracts. ISDA would like to offer its assistance to the Ukraine government as it works to mitigate the risk of any such disadvantages and to promote legal certainty among international market players accessing Ukraine's financial markets. The economic benefits to Ukraine of such reform would be significant, not least because domestic counterparties would be better able to mitigate currency and interest rate mismatches on their balance sheets. We are confident that these measures would further solidify and improve both the domestic Ukraine economy and the standing of Ukraine in the world financial markets.

We hope that our comments are helpful to you during your considerations. ISDA wholeheartedly endorses the spirit underlying your efforts to provide a robust statutory framework and greater legal certainty for Ukraine. We will be very glad for the opportunity, as the legislative process progresses, to work closely with you to address those issues we have identified. If ISDA can be of any help in this process, we hope that you will not hesitate to contact me at the ISDA European Office, One Bishops Square, London E1 6AD, +44 20 3088 3550, pwerner@isda.org.

We understand that several Ukrainian authorities co-operate on matters such as this one. Hence, we thought it appropriate to send this letter to the Ministry of Finance, National Bank of Ukraine and the Commissioner of the Securities and Stock Market State Commission.

Sincerely,

Dr Peter M Werner
Director of Policy
pwerner@isda.org

APPENDIX A**CERTAIN TRANSACTIONS UNDER THE ISDA MASTER AGREEMENT**

Basis Swap. A transaction in which one party pays periodic amounts of a given currency based on a floating rate and the other party pays periodic amounts of the same currency based on another floating rate, with both rates reset periodically; all calculations are based on a notional amount of the given currency.

Bond Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a bond of an issuer, such as Kingdom of Sweden or Unilever N.V., at a specified strike price. The bond option can be settled by physical delivery of the bonds in exchange for the strike price or may be cash settled based on the difference between the market price of the bonds on the exercise date and the strike price.

Bullion Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified number of Ounces of Bullion at a specified strike price. The option may be settled by physical delivery of Bullion in exchange for the strike price or may be cash settled based on the difference between the market price of Bullion on the exercise date and the strike price.

Bullion Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price or a fixed rate and the other party pays periodic amounts of the same currency or a different currency calculated by reference to a Bullion reference price (for example, Gold-COMEX on the New York Commodity Exchange) or another method specified by the parties. Bullion swaps include cap, collar or floor transactions in respect of Bullion.

Bullion Trade. A transaction in which one party agrees to buy from or sell to the other party a specified number of Ounces of Bullion at a specified price for settlement either on a “spot” or two-day basis or on a specified future date. A Bullion Trade may be settled by physical delivery of Bullion in exchange for a specified price or may be cash settled based on the difference between the market price of Bullion on the settlement date and the specified price.

For purposes of Bullion Trades, Bullion Options and Bullion Swaps, “Bullion” means gold, silver, platinum or palladium and “Ounce” means, in the case of gold, a fine troy ounce, and in the case of silver, platinum and palladium, a troy ounce.

Buy/Sell-Back Transaction. A transaction in which one party purchases a security (in consideration for a cash payment) and agrees to sell back that security to the other party (in consideration for the original cash payment plus a premium).

Cap Transaction. A transaction in which one party pays a single or periodic fixed amount and the other party pays periodic amounts of the same currency based on the excess, if any, of a specified floating rate (in the case of an interest rate cap) or commodity price (in the case of a commodity cap) in each case that is reset periodically over a specified per annum rate (in the case of an interest rate cap) or commodity price (in the case of a commodity cap).

Collar Transaction. A collar is a combination of a cap and a floor where one party is the floating rate or floating commodity price payer on the cap and the other party is the floating rate or floating commodity price payer on the floor.

Commodity Forward. A transaction in which one party agrees to purchase a specified quantity of a commodity at a future date at an agreed price and the other party agrees to pay a price for the same quantity to be set on a specified date in the future. The payment calculation is based on the quantity of the commodity and is settled based, among other things, on the difference between the agreed forward price and the prevailing market price at the time of settlement.

Commodity Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified quantity of a commodity at a specified strike price. The option can be settled either by physically delivering the quantity of the commodity in exchange for the strike price or by cash settling the option, in which case the seller of the option would pay to the buyer the difference between the market price of that quantity of the commodity on the exercise date and the strike price.

Commodity Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price and the other party pays periodic amounts of the same currency based on the price of a commodity, such as natural gas or gold, or a futures contract on a commodity (e.g., Light Sweet Crude Oil on the New York Mercantile Exchange); all calculations are based on a notional quantity of the commodity.

Credit Protection Transaction.⁵ A transaction in which one party pays either a single fixed amount or periodic fixed amounts or floating amounts determined by reference to a specified notional amount, and the other party (the credit protection seller) pays either a fixed amount or an amount determined by reference to the value of one or more loans, debt securities or other financial instruments (each a “Reference Obligation”) issued, guaranteed or otherwise entered into by a third party (the “Reference Entity”) upon the occurrence of one or more specified credit events with respect to the Reference Entity (for example, bankruptcy or payment default). The amount payable by the credit protection seller is typically determined based upon the market value of one or more debt securities or other debt instruments issued, guaranteed or otherwise entered into by the Reference Entity. Credit protection transactions may also be physically settled by payment of a specified fixed amount by one party against delivery of specified Reference Obligations by the other party. A credit protection transaction may also refer to a “basket” of two or more Reference Entities.

Credit Spread Transaction. A transaction involving either a forward or an option where the value of the transaction is calculated based on the credit spread implicit in the price of the underlying instrument.

Cross Currency Rate Swap. A transaction in which one party pays periodic amounts in one currency based on a specified fixed rate (or a floating rate that is reset periodically) and the other party pays periodic amounts in another currency based on a floating rate that is reset periodically. All calculations are determined on predetermined notional amounts of the two currencies; often such swaps will involve initial and or final exchanges of amounts corresponding to the notional amounts.

Currency Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified amount of a given currency at a specified strike price.

Currency Swap. A transaction in which one party pays fixed periodic amounts of one currency and the other party pays fixed periodic amounts of another currency. Payments are calculated on a notional amount. Such swaps may involve initial and or final payments that correspond to the notional amount.

Equity Forward. A transaction in which one party agrees to pay an agreed price for a specified quantity of shares of an issuer, a basket of shares of several issuers or an equity index at a future date and the other party agrees to pay a price for the same quantity of shares of an issuer to be set on a specified date in the future. The payment calculation is based on the number of shares and can be physically-settled (where delivery occurs in exchange for payment) or cash-settled (where settlement occurs based on the difference between the agreed forward price and the prevailing market price at the time of settlement).

Equity Index Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right to receive a payment equal to the amount by which an equity index either exceeds (in the case of a call) or is less than (in the case of a put) a specified strike price.

⁵

Some market participants may refer to credit protection transactions as credit swaps, credit default swaps or credit default options.

Equity Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) shares of an issuer or a basket of shares of several issuers at a specified strike price. The option may be settled by physical delivery of the shares in exchange for the strike price or may be cash settled based on the difference between the market price of the shares on the exercise date and the strike price.

Equity or Equity Index Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price or a fixed rate and the other party pays periodic amounts of the same currency or a different currency based on the performance of a share of an issuer, a basket of shares of several issuers or an equity index, such as the Standard and Poor's 500 Index.

Emissions Allowance Transaction. A transaction in which one party agrees to purchase a specified quantity of emissions allowances at a future date at an agreed price and the other party agrees to deliver that quantity of emissions allowances for that agreed price.

Floor Transaction. A transaction in which one party pays a single or periodic amount and the other party pays periodic amounts of the same currency based on the excess, if any, of a specified per annum rate (in the case of an interest rate floor) or commodity price (in the case of a commodity floor) over a specified floating rate (in the case of an interest rate floor) or commodity price (in the case of a commodity floor).

Foreign Exchange Transaction. A transaction providing for the purchase of one currency with another currency providing for settlement either on a "spot", or two-day basis or a specified future date.

Forward Rate Transaction. A transaction in which one party agrees to pay a fixed rate for a defined period and the other party agrees to pay a rate to be set on a specified date in the future. The payment calculation is based on a notional amount and is settled based, among other things, on the difference between the agreed forward rate and the prevailing market rate at the time of settlement.

Interest Rate Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to receive a payment equal to the amount by which an interest rate either exceeds (in the case of a call option) or is less than (in the case of a put option) a specified strike rate.

Interest Rate Swap. A transaction in which one party pays periodic amounts of a given currency based on a specified fixed rate and the other party pays periodic amounts of the same currency based on a specified floating rate that is reset periodically, such as the London inter-bank offered rate; all calculations are based on a notional amount of the given currency.

Physical Commodity Transaction. A transaction which provides for the purchase of an amount of a commodity, such as coal, electricity or gas, at a fixed or floating price for actual delivery on one or more dates.

Swap Option. A transaction in which one party grants to the other party the right (in consideration for a premium payment), but not the obligation, to enter into a swap with certain specified terms. In some cases the swap option may be settled with a cash payment equal to the market value of the underlying swap at the time of the exercise.

Total Return Swap. A transaction in which one party pays either a single amount or periodic amounts based on the total return on one or more loans, debt securities or other financial instruments (each a "Reference Obligation") issued, guaranteed or otherwise entered into by a third party (the "Reference Entity"), calculated by reference to interest, dividend and fee payments and any appreciation in the market value of each Reference Obligation, and the other party pays either a single amount or periodic amounts determined by reference to a specified notional amount and any depreciation in the market value of each Reference Obligation.

A total return swap may (but need not) provide for acceleration of its termination date upon the occurrence of one or more specified events with respect to a Reference Entity or a Reference Obligation with a termination payment made by one party to the other calculated by reference to the value of the Reference Obligation.

Weather Index Transaction. A transaction, structured in the form of a swap, cap, collar, floor, option or some combination thereof, between two parties in which the underlying value of the transaction is based on a rate or index pertaining to weather conditions, which may include measurements of heating, cooling, precipitation and wind.

APPENDIX B

EXAMPLE OF RISK REDUCTION VIA CLOSE-OUT NETTING

Swaps and other derivative transactions can be said to have a value to one or other of the parties. This value derives from the underlying rate, asset or risk to which the derivative relates. For example, the value of a straightforward fixed-for-floating interest rate swap derives from anticipated market interest rates for the currency concerned. To the fixed rate payer, the swap will have a value if, to replace the swap now, it would have to pay a higher fixed rate (in return for LIBOR) than it is required to pay under the existing swap. The swap would be, in that sense, an asset for the fixed rate payer in these circumstances, and a liability for the floating rate payer. In other words, the fixed rate payer is “in-the-money” and the floating rate payer is “out-of-the money”.

Over the course of time, a bank may enter into a number of different interest rate swaps with a counterparty. At any point in time, under some of those swaps the bank may be in-the-money, while under others it may be out-of-the-money. If the counterparty were to become insolvent, the bank would attempt to terminate all outstanding swaps with the counterparty. If all those outstanding swap transactions had been documented under an ISDA Master Agreement, then they would have been entered into on the basis that they constituted a single agreement with the Master Agreement. The purpose of this “single agreement” approaches is to facilitate close-out netting by avoiding “cherry picking”.

The term “cherry picking” refers to a power that some insolvency officials have under the insolvency laws of certain jurisdictions to reject certain contracts burdensome to the insolvent company while affirming contracts beneficial to the insolvent company.

Generally, where an insolvency official has the power to reject or affirm contracts, a counterparty to a rejected contract must file a claim for moneys owed (or for damages) against the estate of the insolvent company in respect of the rejected contract, for which it can expect to receive no more than a fraction of the value, while continuing to perform its obligations to the insolvent company under any affirmed contracts.

If a bank has a number of swaps with an insolvent company, “cherry picking” results in those swaps which are out-of-the-money to the insolvent company being rejected and those swaps which are in-the-money being affirmed. Assuming the swaps are unsecured, the counterparty is in the disastrous position of being forced to pay full value in respect of the swaps which are out- of-the-money to itself while likely to receive only part value (if any) in respect of the swaps which are in-the-money to itself.

The ISDA Master Agreement attempts to overcome this problem by making it clear that the Master Agreement and all transactions entered into under it constitute a single agreement between the parties which must therefore be affirmed or rejected by the insolvency official as a whole.

Normally, upon declaration of an early termination date for a Master Agreement by reason of an insolvency default, all transactions are terminated and their value is determined. As noted above, some of these swaps, depending on rates prevailing at the time of termination, may be in-the-money and some may be out-of-the-money to the non-defaulting party. The values for the swap transactions are converted to a single currency and netted against each other to produce a single “settlement amount”.

The benefits of netting the values of individual transactions upon termination are clear. Suppose a bank had entered into four interest rate swaps with a counterparty which subsequently became insolvent and that on the date the insolvency petition was presented the values of those swaps to the bank were as follows:

Swap 1	U.S.\$7millicn
Swap 2	U.S.\$5 million
Swap 3	U.S.\$-6 million

Swap 4 U.S.\$-3 million

Positive figures indicate that the bank is in-the-money and that the swap is, in that sense, an asset for the bank. Negative figures indicate that the bank is out-of-the- money and that the swap is, in that sense, a liability for the bank.

Assume that the transactions were terminated and valued on the day the petition was presented. If the insolvency official appointed to deal with the counterparty's estate were able to cherry pick, the bank would be obliged to pay U.S.\$9 million, representing the value of the transactions which were, in effect, liabilities of the bank and assets of the counterparty. The bank would also have a claim against the insolvent's estate for U.S.\$12 million, representing the value of the transactions which were, in effect, assets of the bank and liabilities of the insolvent. Assuming the bank was only paid 10% of its claim against the estate, it would have paid U.S.\$9 million and received U.S.\$1.2 million.

If close-out netting, on the terms of the ISDA Master Agreement, were enforceable as against the insolvency official, the bank's position would be significantly improved. A single net sum in respect of all the terminated transactions would be calculated equal to U.S.\$3 million (U.S.\$7 million + U.S.\$5 million - U.S.\$6 million - U.S.\$3 million). The bank's claim against the insolvent's estate would therefore be for U.S.\$3 million. Assuming again a 10% pay-out, the bank would receive U.S.\$300,000. The enforceability of close-out netting in the jurisdiction of the bank's counterparty effectively reduces the bank's credit risk from U.S.\$19.8 million (U.S.\$9 million + U.S.\$10.8 million) to U.S.\$2.7 million (U.S.\$3 million - U.S.\$300,000).

APPENDIX C

COUNTRY	NETTING LEGISLATION AS OF FEBRUARY 2009
Anguilla	Adopted
Argentina	Under Consideration
Australia	Adopted
Austria	Adopted
Belgium	Adopted
Brazil	Adopted
British Virgin Islands	Adopted
Canada	Adopted
Chile	Under Consideration
Colombia	Under Consideration
The Czech Republic	Adopted
Denmark	Adopted
England	*See Footnote
Finland	Adopted
France	Adopted
Germany	Adopted
Greece	Adopted
Hungary	Adopted
Ireland	Adopted
Israel	Adopted
Italy	Adopted
Japan	Adopted
Luxembourg	Adopted
Malta	Adopted
Mauritius	Under Consideration
Mexico	Adopted
New Zealand	Adopted
Norway	Adopted
Pakistan	Under Consideration
Peru	Under Consideration
Poland	Adopted
Portugal	Adopted
Romania	Adopted
Russia	Under Consideration
Slovakia	Adopted
South Africa	Adopted
South Korea	Adopted
Spain	Adopted
Sweden	Adopted
Switzerland	Adopted
United Kingdom	Adopted *
United States	Adopted *

*** United Kingdom**

ISDA provides legal opinions for the laws of England & Wales as well as Scotland. As of February 21, 2009, the UK banking Act introduced a new insolvency law for all UK jurisdictions providing for a special resolution regime for banks and building societies. This includes specific netting legislation for transactions with such counterparties. With regard to most other counterparties the previous regime remains in place. In England, the enforceability of netting is widely accepted without the need for specific statutory recognition. Please refer to the ISDA netting opinions on English and Scots law respectively. For other jurisdictions without specific netting statutes, e.g. Turkey, Netherlands, Hong Kong, please refer to the relevant ISDA netting opinions.

*** United States**

Further amendments to the Bankruptcy Code are under consideration that will provide greater recognition of cross product netting.

APPENDIX D

2006 MODEL NETTING ACT

Part I Netting

1. Definitions

In this Act:

- "Bank" means the Central Bank of *[insert applicable jurisdiction]*;
- "cash" means money credited to an account in any currency, or a similar claim for repayment of money, such as a money market deposit;
 - "collateral" means any of the following:
 - cash in any currency;
 - securities of any kind, including (without limitation) debt and equity securities;
 - guarantees, letters of credit and obligations to reimburse; and
 - 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):
 - a pledge or any other form of security interest in collateral, whether possessory or non possessory;
 - a title transfer collateral arrangement; and
 - 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, conservator 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:
 - the termination, liquidation and/or acceleration of any payment or delivery obligations or entitlements under one or more qualified financial contracts entered into under a netting agreement;
 - the calculation or estimation of a close-out value, market value, liquidation value or replacement value in respect of each obligation or entitlement or group of obligations or entitlements terminated, liquidated and/or accelerated under (i);
 - the conversion of any values calculated or estimated under (ii) into a single currency; and

- the determination of the net balance of the values calculated under (ii), as converted under (iii), whether by operation of set-off or otherwise;
- "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 under the agreement 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 agreement, contract or transaction, including any terms and conditions incorporated by reference in any such financial agreement, contract or transaction, pursuant to which payment or delivery obligations are due to be performed at a certain time or within a certain period of time. Qualified financial contracts include (without limitation):
 - a currency, cross-currency or interest rate swap;
 - a basis swap;
 - a spot, future, forward or other foreign exchange transaction;
 - a cap, collar or floor transaction;
 - a commodity swap;
 - a forward rate agreement;
 - a currency or interest rate future;
 - a currency or interest rate option;
 - an equity derivative, such as an equity or equity index swap, equity forward, equity option or equity index option;
 - a derivative relating to bonds or other debt securities or to a bond or debt security index, such as a total return swap, index swap, forward, option or index option;
 - a credit derivative, such as a credit default swap, credit default basket swap, total return swap or credit default option;
 - an energy derivative, such as an electricity derivative, oil derivative, coal derivative or gas derivative;
 - a weather derivative, such as a weather swap or weather option;
 - a bandwidth derivative;
 - a freight derivative;
 - a carbon emissions derivative;
 - an inflation derivative;
 - a spot, future, forward or other commodity transaction;
 - an agreement to buy, sell, borrow or lend securities, such as a securities repurchase or reverse repurchase agreement, a securities lending agreement or a securities buy/sell-back agreement;
 - an agreement to buy, sell, borrow or lend commodities, such as a commodities repurchase or reverse repurchase agreement, a commodities lending agreement or a commodities buy/sell-back agreement;
 - a collateral arrangement;
 - an agreement to clear or settle securities transactions or to act as a depository for securities;

- any other agreement, contract or transaction similar to any agreement, contract or transaction referred to in paragraphs (a) to (v) with respect to one or more reference items or indices relating to (without limitation) interest rates, currencies, commodities, energy products, electricity, equities, weather, bonds and other debt instruments, precious metals, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial or economic consequence, or economic or financial indices or measures of economic or financial risk or value;
- any swap, forward, option, contract for differences or other derivative in respect of, or combination of, one or more agreements or contracts referred to in paragraphs (a) to (w); and
- any agreement, contract or transaction designated as such by the Bank under this Act;
- "title transfer collateral arrangement" means a margin, collateral or security arrangement related to a netting agreement 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, securities lending agreement, securities buy/sell-back 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, contract or transaction, or type of agreement, contract or transaction, 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, gambling, wagering or 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

(i) any action of the liquidator,

(ii) 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

(iii) 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.** After commencement of insolvency proceedings in relation to a party, the only obligation, if any, of either 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.** After commencement of insolvency proceedings in relation to a party, the only right, if any, of either 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 or transactions will not prevent the termination, liquidation and/or acceleration of all payment or delivery obligations or entitlements under one or more qualified financial contracts entered into under or in connection with 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 determination of a net balance of the close-out values, market values, liquidation values or 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 under or in connection with 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 under or in connection with 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) Pre-emption. 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, contracts 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 agreements, contracts or transactions that fall within the definition of "qualified financial contract" in 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, contracts 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 agreements, contracts or transactions that fall within the definition of "netting agreement" or "qualified financial contract" entered into thereunder in 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 agreement.

(iv) For the purposes of this section, the term "netting agreement" shall include the term "multibranch netting agreement" (as defined in Part II of this Act), provided, however, that in a separate insolvency of a branch or agency of a foreign party (as defined in Part II of this Act) 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 non-insolvent party with the branch or agency of the foreign party in [insert applicable jurisdiction] 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 non-insolvent party with the branch or agency of the foreign party in [insert applicable jurisdiction] 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 multibranch netting agreement provided for payments to either party, upon termination of qualified financial contracts thereunder, 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;

"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 of this Act, 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 in [insert applicable jurisdiction] under a multibranch netting agreement shall be calculated as of the date of the termination of the qualified financial contracts entered into under 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 under this section of the insolvent] branch or agency i of the foreign party or its the liquidator shall be

reduced by any amount otherwise paid to or received by the non-insolvent 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 the non-insolvent party shall be reduced by the fair market value of, or the amount of any proceeds of, collateral that secures or supports the obligations of the foreign party under the multibranch netting agreement and has been applied to satisfy the obligations of the foreign party pursuant to the multibranch netting agreement to the non-insolvent party.

(b) Limitation on the foreign 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 its home country or any other country 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 of, or the amount of any proceeds of, collateral that secures or supports the obligations of the non-insolvent party and has been applied to satisfy the obligations of the non-insolvent party pursuant to such multibranch netting agreement to the foreign party.

3. 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 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 foreign party.

MEMORANDUM ON THE IMPLEMENTATION OF NETTING LEGISLATION

A Guide for Legislators and Other Policy-Makers

March 2006

The International Swaps and Derivatives Association, Inc. (ISDA) has recently published the 2006 Model Netting Act (the **2006 MNA**). The 2006 MNA is a model law intended to set out, by example, the basic principles necessary to ensure the enforceability of bilateral close-out netting, including bilateral close-out netting on a multibranch basis, as well as the enforceability of related financial collateral arrangements.⁶

The 2006 MNA is an updated version of our 2002 Model Netting Act, which was in turn an updated version of our 1996 Model Netting Act. The 1996 and 2002 Model Netting Acts have both been used successfully as models for netting legislation in a number of jurisdictions and as a guide for policy-makers and educators to the basic principles that should underlie a comprehensive statutory regime for close-out netting.

The 2002 Model Netting Act extended the coverage of the 1996 Model Netting Act, in various ways to reflect the evolution of the financial markets, including providing protection to financial collateral arrangements entered into in connection with a netting agreement. The 2006 MNA similarly updates and extends the 2002 MNA.

⁶ In this Memorandum we refer to "netting law" or "netting legislation" and to "netting" or "close-out netting" for ease of reference. References to "netting law" or "netting legislation", are intended to encompass both the close-out netting and collateral aspects of the legislation.

The purpose of this Memorandum is to provide practical advice and guidance to governmental officials and other policy-makers in countries that are currently considering implementing netting legislation.⁷ In preparing this guidance, we have drawn on:

- Our experience over the past 20 years of dialogue with law-makers, regulators and other government officials in countries around the world, from a variety of legal traditions, seeking to implement netting legislation locally in order to strengthen and modernize their national financial markets and to ensure the competitiveness of their leading financial institutions and other professional financial market participants in the global marketplace
- Our collection of detailed reasoned legal opinions, annually updated, on close-out netting under the ISDA Master Agreements from nearly fifty jurisdictions⁸

In preparing this Memorandum, we have had particular regard to the experience and concerns of civil law jurisdictions, although we intend the general principles discussed below to be of assistance to national authorities in jurisdictions representing all legal traditions. We recognize that in many countries it will not necessarily be feasible, as a matter of theory or practice, to implement the 2006 MNA substantially in the form in which we have published it. Equally, in preparing the 2006 MNA we have taken care to avoid using legal concepts that would be specific to a given legal [culture (e.g., common law as opposed to civil law)]. The 2006 MNA is generic in the sense that its provisions are self-contained and generally do not rely on jurisdiction-specific concepts.

We are aware that actual netting legislation sharing the same purpose as the 2006 MNA will often need to be in a form which substantially differs from the generic form set out in the 2006 MNA. This may be for a variety of reasons, ranging from technical (e.g., taking into account existing local legal concepts or doctrines) to legal-cultural (e.g., the detailed style of drafting adopted in the 2006 MNA may be considered inappropriate in jurisdictions of the civil law tradition).

We demonstrate in this Memorandum how the 2006 MNA may, nonetheless, be used even in civil law jurisdictions as a starting point for the preparation of appropriate legislation. We also make certain methodological suggestions to facilitate the effective translation of the provisions of the 2006 MNA into a body of provisions that takes into account these various local requirements while achieving effectively the purposes of the 2006 MNA.

1. PRELIMINARY CONSIDERATIONS

1.1 The objectives of netting legislation

In summary, the primary purpose in adopting netting legislation should be to ensure the enforceability of close-out netting upon the occurrence of any termination event or event of default under the netting agreement, both prior to and following the commencement of insolvency proceedings, in each case in accordance with the terms of the parties' contract. This purpose can be achieved in a variety of ways. For instance, in a legal system where there only exist specific and well-identified issues which may conflict with the enforceability of close-out netting as described in the 2006 MNA, it would in theory be possible to adopt netting legislation with specific objectives of resolving these issues so that the overall purpose of enforceability of close-out netting would be achieved. While a benefit of this approach would be to achieve the desired result in a very economical way, the resulting local legislation may be very technical and hardly accessible to non-specialist lawyers.

⁷ ISDA gratefully acknowledges the assistance of the Paris; New York and London offices of Allen & Overy LLP in the preparation of this Memorandum.

⁸ A list of the jurisdictions from which ISDA has obtained netting opinions appears on our website at <http://www.isda.org>, together with a list of the jurisdictions around the world that have enacted or are considering enacting netting legislation. We also have commissioned and obtained detailed reasoned legal opinions on collateral arrangements under ISDA's Credit Support Documents from over 35 countries. Summaries of the netting opinions have been made available to ISDA members on a subscription basis via an on-line service known as **netalytics**. Summaries of the collateral opinions are also available to ISDA members on a subscriptions basis via a comparable on-line service known as **CSAnalytics**. Details of each service are on the ISDA website.law). The 2006 MNA is generic in the sense that its provisions are self-contained and generally do not rely on jurisdiction-specific concepts.

Alternatively, legislators may choose to adopt an approach which goes beyond addressing the already identified issues and more generally confirms the effectiveness of close-out netting and the various intermediate steps. This is the approach adopted by the 2006 MNA, the provisions of which analytically approach the close-out netting process in its various phases (pre insolvency in respect of the potential conflict between gaming laws and the enforceability of qualified financial contracts, post insolvency, single-branch and multi-branch), while systematically addressing the legal issues which have been found to apply most commonly (principally, of course, insolvency laws).

The benefits of this approach are numerous:

- the resulting legislation is more accessible and self-explanatory; and
- it is generally more robust than specific legislation which will only address a limited number of known issues but provides no protection against subsequent developments.

Whatever final approach is decided, we suggest, as a first step, that careful consideration should be given to identifying in detail the relevant areas of local law which could potentially conflict with the effectiveness of netting agreements, so that all relevant issues are adequately covered by local legislation. These would typically fall in one or more of the following categories:

- insolvency laws (including provisions of local law enacted for the prevention of insolvency), which most frequently are the primary obstacle;
- any specific mandatory provisions enacted for the protection of debtors generally (*i.e.*, in addition to insolvency law) or for the protection of certain categories of debtors;
- gaming laws; and
- less frequently, general principles of contract law.

1.2 Policy considerations

We suggest that careful consideration be given to identifying any relevant local policy considerations that may be relevant in the context for the adoption of netting legislation, so that the scope of the netting legislation is defined with clarity.

Defining the scope of the legislation has a technical aspect (defining, for example, through the use of legal definitions or legal concepts the transactions or the parties that will benefit from the netting law) but also has a more political aspect, since by defining the scope of the netting law the legislator will necessarily make policy choices. For example, law makers may decide that, because the benefit of netting legislation involves a regime which derogates from the normally applicable insolvency rules, these derogations may only be justified:

- in favor of certain eligible parties (in which case the scope of the legislation will be restricted by reference to such parties - *rationes personae*); and/or
- in certain specific contexts (in which case the scope of the legislation will be restricted by reference to such matters - *ratione materiae*).

In order to be able to define clearly the scope of the netting legislation (see below), those drafting the legislation must decide beforehand a specific policy that will apply in the relevant jurisdiction in relation to the financial transactions covered by the netting legislation. Obviously, these policy choices will be influenced by broader policies reflected in the laws of the relevant jurisdiction. For example, a jurisdiction in which insolvency law is more favorable to the insolvent party than to its creditors might be tempted to draft netting legislation which reflects this policy.

In formulating its policy choices, law makers in a jurisdiction should, however, distinguish between regulatory policy issues and systemic risk issues. It may be appropriate, by law or regulation, to limit certain types of financial activity to certain types of market participants subject to appropriate conditions and limitations. It does not necessarily, however, make sense to limit the effectiveness of close-out netting by reference to types of market participants. The systemic risk reduction of effective close-out netting benefits all potential market participants, including corporations, insurance companies, special purpose vehicles used for structured financings, governmental authorities, charitable organizations hedging in the market, private individuals and so on. In other words, it reduces credit risk both for solvent and insolvent parties, and reduces the risk of a large insolvency have a "domino" effect on the solvency of other market participants who have dealt with the insolvent.

Although existing netting legislation in some countries does limit eligibility for the benefits of close-out netting to certain categories of market participant, such limitations do not necessarily make sense from a system risk point view. They potentially lead to difficult issues of characterization in relation to certain market participants, therefore creating legal uncertainty, and require periodic updating to reflect the continuing evolution of a dynamic market.

2. DEFINING THE SCOPE OF NETTING LEGISLATION

Once the policy choices in relation to the scope of the netting legislation have been made, those drafting the legislation will need to translate those choices into draft statutory provisions that are consistent with the relevant local legal concepts and categories.

We suggest that the provisions of the 2006 MNA will be helpful in this exercise, as the 2006 MNA may be read as a "check-list" of issues, among other things, permitting legislators that assess whether local legal concepts used to define the scope of the draft legislation are compatible with the overall purpose of the legislation.

2.1 Defining the scope of local legislation *ratione materiae*

While it is in theory possible to draft netting legislation which would cover all types of financial transactions without distinction, the scope of most actual netting legislation will seek to clarify in some way or other the types of financial transaction that benefit from the netting regime. It is clearly important to do this in a way that both provides that greatest amount of legal certainty as to scope but also is capable of accommodating continuing development and innovation in the financial markets.

Section 1 of the 2006 MNA provides a definition of "qualified financial contract" which lists the various types of financial transaction that should ideally be covered. It also includes broad wording at the end of the definition intended to capture all types of financial transaction of a comparable nature in a way that is flexible enough to accommodate the development of new products. This avoids the need to introduce amending legislation periodically in order to keep pace with the markets, as has happened in a number of countries that introduce early netting statutes that were relatively restricted in scope.

In a number of jurisdictions, the specific style of the definition of "qualified financial contract" in section 1 of the 2006 MNA will probably be felt to be inappropriate insofar as it simply purports to describe extrinsic market realities rather than attempting to cover the same products using existing legal concepts. Legislators may prefer, for example, to consider referring to broad legal concepts such as "forward contracts" or "forward financial instruments". The definition of the financial instruments should be broad enough to cover not only derivative types of transactions but also repurchase transactions and securities lending transactions that should benefit from the same favorable netting regime, as related financial collateral arrangements.

While it is obviously possible to define qualifying transactions using traditional legal concepts in the relevant jurisdiction, legislators should consider the following:

- A single existing category will often be insufficient to cover the broad range of products meant to be covered by the 2006 MNA. For instance, in many civil law jurisdictions, the concept of a forward contract would typically cover derivatives generally but would not cover many products listed by the 2006 MNA ("spot" transactions, securities lending, repurchase transactions, collateral, clearance and settlement transactions, etc.). A combination of concepts would in most cases be inevitable.
- Traditional legal concepts originating decades ago may be inappropriate to describe with clarity and certainty more recent products listed by the 2006 MNA or to cover future financial innovations.

As a result, certain jurisdictions which traditionally tended to use their existing legal concepts have introduced a more pragmatic approach by introducing descriptive language in their statutory provisions on financial matters as this often proves to be the only efficient way to clearly cover a broad range of products which may span traditional legal categories.

In addition to the use of generic language of the type reflected at the end of the definition of "qualified financial contract" in section 1 of the 2006 MNA, Part I section 2 of the 2006 MNA provides that the Central Bank of the relevant jurisdiction should be able to designate as "qualified financial contracts" any agreement or contract in addition to those already listed in the 2006 MNA. Where the Central Bank has this authority, it may use it in relation to a newly developed product, to enhance legal certainty in relation to that developing market.

Such provisions would give more flexibility to the definition of the financial instrument to be covered by the netting legislation. However, local legislators should check whether this suggestion makes sense from a constitutional perspective under local law. If such an approach is not possible under the laws of the relevant jurisdiction, it is particularly important to make sure that the definition of financial instruments covers all types of instruments, currently existing or contemplated, which are supposed to be included in the netting legislation.

Finally, we suggest that the definition *ratione materiae* of the scope of future netting legislation may be a good opportunity to clarify certain legal issues which may interfere with the enforceability of certain financial transactions defined under the netting law. For example, there is some uncertainty under certain legal systems as to the possible characterisation of derivative transactions as unenforceable gaming contracts. Some discussions have also arisen in various jurisdictions as to the possible characterisation of credit protection transactions such as credit default swaps (CDS) as guarantee or insurance contracts. Although the objective of the netting law would typically not be to deal with these issues, the definition of qualifying transactions could be the opportunity for the legislator to clarify any identified uncertainty in these respects.

2.2 Defining the scope of local legislation *ratione personae*

After defining which type of financial transactors will be covered by the netting legislation, those preparing draft legislation should, if appropriate, define the parties who will be eligible to benefit from the special netting regime. As set out above, the choice of the eligible parties is important in terms of policy considerations.

The scope *ratione personae* has been, for example, heavily discussed during the drafting and implementation of the European Collateral Directive (the **Directive**), which covers a number of issues related to netting. The Directive offered European Member States the option to exclude non-regulated entities (*i.e.* mainly corporate entities) from the scope of national legislation implementing the Directive (the so-called "opt-out" of article 1(3) of the Directive). When implementing the Directive, most European jurisdictions decided to include both financial and non-financial entities within the scope of the netting legislation. Certain countries, such as Austria, the Slovak Republic or Sweden, excluded non-financial entities. An alternate solution was adopted by France, which decided that non-financial entities should benefit from the netting regime for transactions entered into with a "regulated" entity (*i.e.* mainly a

financial entity, an investment fund or certain public law governed entities) where these transactions are linked to financial instruments.

The definition of "person" in Part I section 1 of the 2006 MNA may be used as a framework for excluding certain persons from the scope of the netting legislation:

"person" includes [individuals], [partnerships], [corporations], [other regulated entities such as banks, insurance companies and broker-dealers], [governmental units];"

Here again, those preparing draft legislation may consider referring to the exact legal concepts in the law of the relevant jurisdiction to define the relevant persons. For example, if the laws of the relevant jurisdiction provide for a definition of "banks", it would be useful in terms of clarity to refer to this definition.

There are, however, as discussed in part 1.2 of this memorandum, strong policy and practical considerations in favor of adopting as broad a scope as possible for close-out netting legislation and dealing with other policy concerns via financial regulation or other appropriate legislation that does not affect the enforceability of close-out netting against the broad range of financial market participants.

2.3 Netting and collateral arrangements

Once the eligible transactions and eligible parties (if necessary) have been defined, the draft netting legislation needs to define the netting agreements which will be covered. The 2006 MNA gives a broad definition of "netting agreement" which covers master agreement, master-master netting agreement as well as collateral arrangements related to these types of agreements or master-master agreements:

"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 under the agreement 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;"

It is worth noting that this definition again avoids relying on jurisdiction-specific legal concepts and simply attempts to describe the economic effects intended by the parties in their netting agreement. This approach may prove difficult to translate in certain legal systems that traditionally organize or regulate a specific legal concept of "set-off" (e.g., *compensation* under the French civil code), which refers to a payment mechanism whereby respective obligations may be discharged. In such cases, it would be worth using the definition of "netting" provided by the 2006 MNA to clarify that netting, for these purposes, is a complex reality which involves:

- the termination or acceleration of the future payment and delivery obligations under the relevant individual transactions (but not the netting agreement itself which should not be required to be terminated);
- the valuation of the respective exposures of the parties thereunder at the time of termination (which may also be thought of as valuing the costs to each party of replacing each terminated transaction with a new transaction concluded with a third party in the market at that time); and
- the computation of a netted termination amount in a single currency reflecting such net exposures as well as the set-off of respective obligations in respect of amounts which were already due and payable.

The 2006 MNA does not list specific types of agreements (e.g., the 2002 ISDA Master Agreement), which avoids restricting the netting regime to specific agreements only. In certain jurisdictions the use of specific domestic documentation governed by the law of the jurisdiction may be common. It is consequently suggested that the netting legislation should adopt a broad definition covering domestic as well as

international industry standard documents, irrespective of their governing law and to avoid restrictions limiting, for example, eligible agreements to those approved by a specific authority. In many countries where such restrictions had been initially introduced (*e.g.*, France), they have proved inappropriate both for reasons of principle and for all practical purposes: it is indeed questionable whether any, public authority has relevant competence to determine the appropriateness of a given standard to govern privately negotiated contracts. In addition, such restrictions create legal uncertainty, as the relevant public authority will inevitably take considerably more time to approve new documentation or evolutions of existing documentation than the time it will typically take for the markets to adopt such documentation.

In respect of the close-out netting provisions, the netting legislation will, as set out above, need to specify that the eligible transactions which are subject to the, close-out netting can be governed by one or more master agreements to allow the use of bridge or master-master-agreements between various agreements governing different types of transactions.

It is worth noting that the definition of "netting agreements" provided by the 2006 MNA refers to collateral arrangements. This allows the close-out netting process to incorporate effectively exposures under related collateral arrangements.

In this respect, the netting law should only refer to the collateral arrangements which are authorized and enforceable under the law of the relevant jurisdiction. The purpose of the netting law is not to define and ensure the validity and enforceability of collateral arrangements. Collateral arrangements raise important legal questions (*e.g.*, type of collateral arrangements, type of collateral which can be used, conditions under which collateral can be taken or given, form of the agreements, perfection, foreclosure, etc.) which need to be addressed, if this has not already been done under the laws of the relevant jurisdiction, by specific legislation.

On the other hand, title transfer collateral arrangements are often integrated into the mechanism of the netting agreement to which they relate (and they are, in the 2006 MNA, included within the definition of "netting agreement" and "qualified financial contract"). It is preferable from a systemic risk point of view to ensure that such arrangements are included within the scope of any netting legislation implemented.

3. CONFIRMING THE ENFORCEABILITY OF NETTING AGREEMENTS

Once the scope of the netting legislation has been defined, adequate operative provisions will be required to effectively implement the purpose described above, namely the enforceability of close-out netting upon the occurrence of any termination event or event of default under the netting agreement, both prior to and following commencement of insolvency proceedings, in each case in accordance with the terms of the parties' contract.

In many jurisdictions, the main obstacles relate to the situation where one of the parties is subject to insolvency proceedings. However, as discussed above, local legislators should make sure that the proposed provisions will also resolve any other legal issue which could potentially interfere with such enforceability.

3.1 General

As set out above, the netting legislation should confirm the enforceability of close-out netting upon the occurrence of any termination event or event of default under the netting agreement, both prior to and following commencement of insolvency proceedings, in each case in accordance with the terms of the parties' contract. Part I section 4(a) of the 2006 MNA expressly confirms that the provisions of a netting agreement will be enforceable in accordance with their terms even if the counterparty is subject to insolvency proceedings.

The 2006 MNA does not give a list of termination events or events of default which would allow the parties to the netting agreement to terminate the underlying transactions. These events will be provided by the netting agreement entered into by the parties. When referring to the termination of the transactions, we

suggest that local legislators use the approach adopted by the 2006 MNA and simply refer to the agreement of the parties.

Netting legislation should not require "termination" of the netting agreement itself since only transactions terminate. The netting agreement should survive so that its netting provisions can effectively be performed. The netting law should also provide that the inclusion of non-eligible transactions under the netting agreement would not destroy close-out netting for the remaining eligible transactions under the netting agreement. For example, if the netting law refers to "forward financial instruments", the inclusion in the netting agreement of spot transactions which do not constitute forward financial instruments should not prevent the parties from being able to close-out the transactions which comply with the definition of forward financial instruments and should not affect the validity of the netting agreement. In this respect, Part I section 4(i) of the 2006 MNA refers expressly to the fact that a netting agreement should be enforceable even if this netting agreement contains transactions that are not "qualified financial contracts". In this case, pursuant to the 2006 MNA, the netting arrangement should only apply to the agreements, contracts or transactions that fall within the definition of "qualified financial contract".

Finally, once the relevant transactions are terminated, the provisions of the netting agreements provide for the calculation of a single net amount which, in principle, will be owed by one party to the other. Consequently, the netting legislation should specify that the only obligation or entitlement due to or from a party to a netting agreement upon close-out netting of transactions is its net obligation or entitlement as determined in accordance with the terms of the netting agreement. This is the objective of Part I sections 4(b) and 4(c) of the 2006 MNA. Again, it is stressed that the netting legislation should not limit itself to confirming the availability of set-off of the separate obligations owed under each transaction, but should instead recognize the single net obligation or entitlement for all transactions which results from the close-out netting process.

3.2 Enforceability outside insolvency proceedings

It is quite likely that most of the civil law jurisdictions would recognize the enforceability of netting agreements outside the scope of insolvency proceedings.

However if this is not the case, the netting legislation should ensure the enforceability of close-out netting and collateral arrangements upon the occurrence of any termination event or event of default under the netting agreement in accordance with the terms of the parties' contract. Consequently, the netting law should set out clearly that despite the rules which could conflict with the effectiveness of the netting and collateral provisions, these provisions will be enforceable. In this respect the 2006 MNA only sets out in Part I section 3 that qualified financial contracts shall not be unenforceable by reason of laws relating to gaming contracts.

Such provisions will only need to be included in the netting law if the netting and collateral provisions are not enforceable without such clarification. If the relevant law already sets out that similar netting mechanism or collateral arrangements are already enforceable in respect of counterparties which are not subject to insolvency proceedings, the netting law would not need to make such specification as it would be redundant and could create some uncertainty as to why such provision is necessary. The legislator will consequently need to take into consideration the legal provisions which already regulate contractual netting in the local jurisdiction either to draft accordingly the netting law, if contractual netting is already authorized or to specify clearly that the netting legislation should be an exception to the more general contractual netting provisions if it is necessary.

In addition, legislators should also ensure that the netting legislation will recognize the enforceability of the netting arrangements if the defaulting party is subject to any attachment procedures from third parties.

3.3 Enforceability in the case of insolvency proceedings

The protection of the netting legislation is crucial where one party to the qualifying transaction is subject to insolvency proceedings. This explains the particular focus in the 2006 MNA on enforceability vis-à-vis an insolvent party and any insolvency official.

Insolvency law, in particular in countries where the insolvency provisions are more favorable to the insolvent debtor than to the creditors of the insolvent party, might not authorize close-out netting of transactions where one party is subject to insolvency proceedings.

Prohibition of Termination

Typically, insolvency laws might limit the effectiveness of contractual termination provisions when they are triggered on the basis of the opening of the insolvency proceedings. Given the importance of termination in the close-out netting process, the 2006 MNA goes beyond the general affirmation of the enforceability of netting agreements provided in Part I section 4(a) and provides in section 4(d) that a liquidator shall not be able to prevent the termination of any qualified financial contracts or the acceleration of any payment owed under these qualified financial contracts.

"Cherry-Picking"

In addition, under insolvency legislation, the liquidator often has the right to require the continuation of or, on the contrary, to repudiate transactions entered into by the insolvent party. When these prerogatives exist, they create a risk of "cherry-picking" whereby the liquidator could potentially decide to continue any transaction which is "in-the-money" for the insolvent party while repudiating any "out-of-the money" transactions. This would obviously undermine the entire netting mechanism. Legislators should accordingly consider introducing in the netting legislation provisions similar to the provisions of Part I section 4(d) of the 2006 MNA to prevent the liquidator from "cherry-picking" only specific transactions within the netting agreement.

Limitations on set-off

Many bankruptcy laws limit the availability of set-off in an insolvency. For example, in certain civil law jurisdictions, respective obligations are only available for set-off when they have fallen due; even when they are due, set-off will only be possible with respect to respective obligations which either arise under the same agreement or are otherwise strongly interconnected (this is sometimes referred to as the "connexity" requirement). Such requirements might jeopardize the effectiveness of netting agreements. The provisions of the netting law will need to address these issues as suggested in Part I section 4(e) of the 2006 MNA, which provides for the recognition of set-off in a way which is compatible with the mechanisms of typical netting agreements.

Preferences

The netting law will also need to ensure that any payment or transfer of collateral made in respect of the transactions during any "preference period" or "suspect period" are not treated as a preference and are consequently not avoidable, as this is frequently the case under bankruptcy law. Part I section 4(f) of the 2006 MNA expressly sets out that a liquidator of an insolvent party may not avoid a transfer or a payment on the ground of it constituting a preference or transfer during a suspect period by the insolvent party to the non-insolvent party.

Other Considerations

The 2006 MNA takes the approach of affirming in each case where insolvency provisions could conflict with the netting provisions the validity of the netting and collateral arrangements over these insolvency provisions. In this respect, civil law jurisdictions might prefer not to list each and every situation which could be problematic but instead to override or disapply all the relevant provisions of the insolvency law which would apply to the relevant type of counterparty in case of insolvency proceedings.

French law, for example, specifies in an article of its monetary and financial code that close-out netting is valid under French law and in a subsequent article confirms that none of its insolvency provisions may interfere with the application of the first article.

Consequently, by "disapplying" all the insolvency law provisions instead of affirming in certain specific situations that the netting and collateral arrangements will be valid, French law sets out clearly that insolvency law may not be used to challenge the principle of the validity of close-out netting and precludes the risk of failing to enumerate any specific cases which could be problematic.

In any event, as set out above, Part I section 4 should be used by those preparing legislation as a "check-list" when "disapplying" insolvency law provisions which might conflict with the netting provisions. Please note that the list of issues addressed by the 2006 MNA is not exhaustive and other issues may need to be considered under the laws of the relevant jurisdiction.

Finally, it is important for the: netting legislation to include in the reference to the insolvency proceedings all types of insolvency proceedings. It should, for example, include judicial proceedings but also voluntary arrangements with creditors or the inability of the debtor to pay its debts as they become due. Insolvency proceedings should consequently cover bankruptcy, liquidation (judicial or voluntary), winding-up, reorganisation, composition, administration, receivership, rehabilitation, conservatorship and any similar or additional measure under the laws of the relevant jurisdiction. In addition, the netting legislation should also cover "all similar proceedings" to ensure that any new types of proceedings which could be introduced under the relevant law will be included in the scope of the netting legislation.

4. MULTIBRANCH NETTING

Netting legislation should permit multibranch netting when a master agreement is entered into with a party which has a head office in a jurisdiction and various branches in other jurisdictions, including in the local jurisdiction. Part II of the 2006 MNA provides detailed provisions that are intended to ensure the effectiveness of multibranch netting in the event of the cross-border insolvency of a multibranch bank.

Statutory provisions comparable to Part II of the MNA are particularly important in jurisdictions that provide for a ring-fencing of the assets and/or liabilities of an insolvent local branch. Such ring-fencing would otherwise potentially undermine the effectiveness of the netting mechanism, which is supposed to operate globally on the basis of all respective obligations and entitlements of the parties, irrespective of the place of booking of individual transactions.

The multibranch provisions of the 2006 MNA are based on the New York banking law provisions 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.

It is necessary for local legislators to consider whether ring-fencing applies in their own jurisdiction and, if so, consider the appropriateness of provisions similar to those set out in Part II of the 2006 MNA. Obviously, if ring fencing does not apply, then these provisions should not be necessary.

As we have been over the past 20 years, ISDA is always willing to provide practical support, including information regarding global financial market practice, to national lawmakers, regulators and other government officials engaged in developing netting legislation or other law reform initiatives relating to the financial markets.

