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## 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.<sup>1</sup>

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.

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.<sup>2</sup> 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

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<sup>1</sup> 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.

<sup>2</sup> ISDA gratefully acknowledges the assistance of the Paris, New York and London offices of Allen & Overy LLP in the preparation of this Memorandum.

- Our collection of detailed reasoned legal opinions, annually updated, on close-out netting under the ISDA Master Agreements from nearly fifty jurisdictions<sup>3</sup>

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.

Alternatively, legislators may chose 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

<sup>3</sup> 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.

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 – *ratione 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 transactions 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. For further information in relation to ISDA's activities in this regard or to request such support or information, please do not hesitate to contact David Geen ([dgeen@isda.org](mailto:dgeen@isda.org)), General Counsel, Katherine Tew Darras ([kdarras@isda.org](mailto:kdarras@isda.org)), General Counsel, Americas, or Peter Werner ([pwerner@isda.org](mailto:pwerner@isda.org)), Policy Director.