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Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
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International Organization of Securities Commissions
Oquendo 12
SP-28006 Madrid
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Cross-Product Netting

Ladies and Gentlemen:

The International Swaps and Derivatives Association, Inc. ("ISDA") and The Bond Market Association ("TBMA") are pleased to have the opportunity to offer comments on the April 2005 Consultative Document entitled "The Application of Basel II to Trading Activities and the Treatment of Double Default Effects" (the "Consultative Document").

ISDA is an international financial trade association whose membership includes more than 600 of the world's largest commercial, merchant and investment banks, corporations, government entities and other institutions from 47 countries on six continents. Its members are the leading participants in the privately negotiated, or over-the-counter ("OTC"), derivatives industry. ISDA is committed to promoting the development of sound risk management practices. Its work includes efforts to ensure adequate legal and regulatory treatment of 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 OTC derivatives transactions worldwide.¹

TBMA is the trade association representing the largest securities markets in the world, the estimated \$44 trillion debt markets. As the industry's voice, TBMA speaks for the global bond industry, advocating its positions and representing its interests. TBMA represents a diverse mix of securities firms and banks, whether they are large, multi-product firms or companies with special market niches. In particular, TBMA has published standard form master agreements that are the leading standard form documents for repurchase agreements and securities loans worldwide.² TBMA has worked with regulators in jurisdictions around the world to promote the legal enforceability of the close-out netting mechanism in its master agreements.

Executive Summary

This letter will concentrate on issues raised by the analysis of cross-product netting in paragraphs 22-31 of the Consultative Document and the proposed Cross-Product Netting Rules set forth in paragraphs 94-105 of the Consultative Document.³ We will present our comments on the proposed Cross-Product Netting Rules in two parts. Part I will discuss the statements in paragraph 29 of the Consultative Document to the effect that the enumerated legal and operational criteria for cross-product netting are not widely met so that a consultation among national supervisors needs to take place to determine when the practice of netting across OTC derivatives and securities financing transactions has reached a sufficient level of legal certainty and usage in the industry as

¹ 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.

² TBMA has published:

- (1) the Master Repurchase Agreement in 1996;
- (2) the Master Securities Loan Agreement in 2000 (published by TBMA and the Securities Industry Association); and
- (3) the Global Master Repurchase Agreement in 2000 (published by TBMA and the International Securities Market Association).

³ We are not offering any comments on the "Operational Criteria" in paragraphs 103 and 104 of the Consultative Document.

to merit its general recognition for purposes of capital computation. Part II will present several more technical comments on the proposed Cross-Product Netting Rules.

To summarise the points made in Part I:

- The legal enforceability of cross-product netting is sufficiently certain at this time to warrant recognition of the net exposure for regulatory capital purposes for many counterparties in many important jurisdictions;
- Cross-product netting is used with certain counterparties, particularly under prime brokerage agreements, and banks and other dealers have systems that can readily be adjusted to manage counterparty credit risk on that basis;
- Capital barriers to the use of enforceable risk management tools have a significant negative impact on market practice and activity;
- A requirement for further international consultation among national supervisors on cross-product netting would have a chilling effect on increased use of improved documentation and risk management practices as well as on legal improvements. Instead, the Cross-Product Netting Rules should reward the improvements achieved to date and encourage further gains by recognising the enforceability of cross-product netting;
- In particular, a requirement for international consultation among supervisors to determine that cross-product netting has reached a "sufficient level" of "usage" in the industry is unsound because it fails to provide incentives to individual firms to lead the industry in terms of risk management; and
- More generally, the Basel II capital rules should serve to motivate increased use of risk mitigation techniques that are legally enforceable.⁴

⁴ Paragraph 30 of the Consultative Document states that cross-affiliate netting is not recognised for the purposes of calculating capital requirements. ISDA and TBMA hope that there will be consultation among national supervisors on this issue in the near future. There is good and growing support for the

To summarise the points made in Part II:

- The proposed Cross-Product Netting Rules should be amended to clarify that they will operate on a stand alone basis; and
- The proposed definition of "walkaway clause" should be modified to provide greater clarity.

I. Legal Enforceability and Operational Practices

ISDA and TBMA believe that the (i) legal enforceability of netting OTC derivatives, on the one hand, against repurchase agreements, securities loans, margin loans and other similar transactions ("SFTs"), on the other hand, is sufficiently certain at this time, and (ii) current ability of banks and other dealers to implement the effects of cross-product netting as part of their risk management systems is sufficient to merit recognising the net exposure for regulatory capital purposes under the proposed Cross-Product Netting Rules.

Master agreements serve as an important means of providing legal certainty, reducing risks and enhancing liquidity in global financial markets. The importance of such master agreements to risk management has consistently been recognised by national and international regulatory authorities and market participants. In their June 1999 report on "Improving Counterparty Risk Management Practices", the Counterparty Risk Management Policy Group (of twelve major, internationally active commercial and investment banks) ("CRMPG") made a number of recommendations for improved documentation practices. The CRMPG report stated: "Parties should make the best possible use of multi-product master agreements, and master-masters, to facilitate obligation netting and collateral netting across product lines". As explained below, TBMA and ISDA responded to this recommendation by publishing documents that facilitate cross-product netting in 2000 and 2001.

Furthermore, regulators have lent strong and active support to cross-product netting. In the U.S., the President's Working Group on Financial Markets published a report on OTC derivatives in November 1999.⁵ This report was transmitted to the U.S. Congress by the Secretary of the Treasury and the Chairmen of the Board

legal enforceability of a number of techniques to achieve cross-affiliate netting, particularly when it involves a non-defaulting party and its affiliates within a single jurisdiction.

of Governors of the Federal Reserve System, the Securities and Exchange Commission and the Commodity Futures Trading Commission. In this report the Working Group reiterated its strong support for then-pending legislation intended to improve the close-out netting regime in the U.S. for OTC derivatives, SFTs and other financial instruments. The Working Group noted that:

"there are improvements currently under consideration by Congress that would, if adopted, reduce systemic risk. Specifically, these proposals would improve the netting regime under the Bankruptcy Code by expanding and clarifying definitions of the financial contracts eligible for netting and by explicitly allowing eligible counterparties to net across different types of contracts, such as swaps, security contracts, repurchase agreements, and forward contracts. . . . Finally, the netting provisions would clarify the netting regime for certain financial contracts in the case of a bank failure. The Working Group believes that these proposals should be enacted into law."⁶

The proposals supported by the Working Group in 1999 became law in the U.S. in April 2005 and, as explained more fully below, make it absolutely clear that close-out netting is enforceable against many U.S. counterparties across OTC derivatives and SFTs. The legislatures of Germany, France and other countries have also listened to the voices that have called for a strengthening of the enforceability of cross-product netting.⁷

Now that the industry and various legislatures have followed the recommendations to enhance risk management across products, including by means of master agreements and master-master agreements, it would be a step backwards to take a restrictive stance on cross-product netting for capital adequacy purposes. It is also important to keep in mind that risk management practices have improved steadily and more than 20 jurisdictions have adopted laws that support close-out netting. We believe that the Cross-Product Netting Rules should encourage further improvement and legal reform.

In this letter "cross-product netting" refers to bilateral close-out netting across two product categories: OTC derivatives and SFTs. In this Part I we will first describe the methods used to document cross-product netting. We will then analyze support for the legal enforceability of cross-product netting with particular emphasis on the laws of the United States, England, France, Germany, Switzerland and Hong Kong as examples

⁵ "Over-the-Counter Derivatives Markets and the Commodity Exchange Act". The President's Working Group on Financial Markets (Nov. 1999).

⁶ Id. at 33-34.

⁷ As explained below, in jurisdictions such as England, Switzerland and Hong Kong with robust set-off regimes it has not been necessary to enact netting legislation to support cross-product netting.

of how the laws of six important jurisdictions deal with cross-product netting. Finally, we will discuss operational practices with respect to cross-product netting.

A. Documentation of Cross-Product Netting

Cross-product netting can be achieved in several different ways. As discussed below, ISDA and TBMA have developed industry standard documentation that facilitates cross-product netting. These industry standard documents, however, have not yet been widely used. Instead, the most common method to date for documenting cross-product netting is to add provisions to the schedules of ISDA Master Agreements and other industry master agreements for SFTs, or to include those provisions in customer agreements and prime brokerage agreements.⁸ These provisions share certain fundamental characteristics. They include a provision that puts into place a cross-default clause involving all the agreements to which cross-product netting is to be applied. They also include a provision that provides for setoff of the amounts determined under each agreement to which cross-product netting is to be applied after operation of the early termination and close-out netting provisions in each such agreement. ISDA and TBMA believe that the same legal criteria should be applied in assessing the enforceability of these provisions developed by individual institutions to achieve cross-product netting as are applied to industry standard documents that achieve the same result.

In addition to provisions developed by individual institutions, there are currently three other methods used to document cross-product netting based upon industry standard documentation.

The first method is to document OTC derivatives and SFTs under a single master agreement such as an ISDA Master Agreement.⁹ While this method may not be the most widely used, it is used in certain jurisdictions such as in the domestic market in Australia, and, as discussed below, it has strong legal support.

The second method is to document OTC derivatives under an ISDA Master Agreement and to document SFTs under separate industry standard master agreements. Repurchase transactions are often documented under

⁸ Some of these agreements contain provisions for both bilateral and cross-affiliate netting. The presence of cross-affiliate netting provisions should not have any impact on the recognition of bilateral cross-product netting under the Basel II capital rules because their presence generally does not have a negative effect on the enforceability of the bilateral cross-product netting provisions.

⁹ Another example of this approach is the European Master Agreement.

either the Master Repurchase Agreement published by TBMA or the Global Master Repurchase Agreement published by TBMA and the International Securities Market Association. Securities lending transactions are frequently documented under the Master Securities Loan Agreement, the Overseas Securities Lenders Agreement or the Global Master Securities Lending Agreement. The separate master agreements are then linked through use of ISDA's Cross-Agreement Bridge (the "Bridge") published in 2001. The Bridge enables parties to an ISDA Master Agreement to terminate transactions documented under industry standard master agreements (such as those described above) and to incorporate the net close-out amounts calculated in respect of those master agreements within the close-out provisions of an ISDA Master Agreement to reach a single net amount due from one party to the other.

The third method also involves the use of separate master agreements for OTC derivatives and SFTs. In this case the separate master agreements are linked through use of the Cross Product Master Agreement published in February 2000 (the "CPMA").¹⁰ The CPMA acts as a contractual superstructure encompassing any number of bilateral master agreements (the "Principal Agreements") that have been or may in the future be entered into by the parties. The CPMA, in specified circumstances, permits a party which has the right to accelerate and close out all transactions under one Principal Agreement to close out all transactions under all other Principal Agreements listed in a schedule to the CPMA to produce a settlement amount under each Principal Agreement. The settlement amounts are then set off under the CPMA to reach a single net amount due from one party to the other.

As can be seen from the discussion above, there are important common elements in each method of documenting cross-product netting. The provisions developed by individual institutions, the ISDA Master Agreement, the Bridge and the CPMA all involve the following elements:

¹⁰ The CPMA was published by TBMA and endorsed by ISDA, the British Bankers' Association, the Emerging Markets Traders Association, the Foreign Exchange Committee, the International Primary Market Association, the Japan Securities Dealers Associations, the London Investment Banking Association and the Investment Dealers Association of Canada. Version 2 of the CPMA (Cross-Affiliate Netting) was published in June 2003.

- A default or cross-default clause that involves all master agreements and transaction agreements¹¹ to which cross-product netting is to be applied; and
- A provision that provides for the setoff of the termination amounts determined under each master and transaction agreement (or determined pursuant to the cross-product netting provisions themselves) to produce a single net amount due from one party to the other.

Cross-product netting provisions that contain the elements described above and that are enforceable under the governing law or laws of the relevant master agreements and transaction agreements are referred to herein as "Cross-Product Provisions".

B. Enforceability of Cross-Product Netting

The method described above for achieving cross-product netting across OTC derivatives and SFTs under an ISDA Master Agreement has strong and broad legal support. ISDA has received advice from leading counsel in 45 countries on the enforceability of the early termination and close-out netting provisions of the ISDA Master Agreement for many types of insolvent counterparties. The jurisdictions covered by ISDA's netting opinions are set forth in Appendix A. Each ISDA netting opinion addresses netting with certain specified types of counterparties across all the transactions described in Appendix B. The list of transactions addressed in each ISDA netting opinion includes not only various types of OTC derivatives but also several types of SFTs, including repurchase transactions, securities lending transactions and buy/sell-back transactions. ISDA's netting opinions confirm the enforceability of cross-product netting under the ISDA Master Agreement for OTC derivatives and SFTs in 41 countries. The exceptions to this broad international consensus are The Netherlands, Norway, Poland and South Africa, where there are questions or qualifications concerning SFTs.

There is also significant legal support for the enforceability of cross-product netting using a Bridge or a CPMA. TBMA has obtained legal opinions regarding the CPMA for many types of insolvent counterparties under the laws of England, the Cayman Islands, the British Virgin Islands, the Bahamas and Bermuda, which all

¹¹ We assume that each underlying agreement provides for early termination upon a default (including a cross-default) and for appropriate close-out netting procedures for transactions under that agreement.

confirm the enforceability of cross-product netting under the CPMA for OTC derivatives and SFTs. Although the current opinion on the CPMA for the U.S. is limited to "financial institution" counterparties, the changes to U.S. law discussed below will permit a much broader opinion to be delivered.

We would be delighted to give you access to any of these ISDA or TBMA legal opinions if it would be useful. The opinions described above confirm the enforceability of Cross-Product Provisions under industry standard documentation. Of course, customized Cross-Product Provisions would remain subject to the criteria set forth in the proposed Cross-Product Netting Rules, including the legal criteria in paragraphs 96 - 101 of the Consultative Document.

Appendix C provides advice prepared by Allen & Overy lawyers qualified in the U.S., England, France, Germany, Switzerland and Hong Kong addressing the various methods for achieving cross-product netting. This advice demonstrates that the Consultative Document is incorrect when it states in Paragraph 26 that "as a general matter the legal enforceability of netting SFTs against OTC derivatives is not sufficiently certain at present to merit recognizing the net exposure for regulatory capital purposes".

For example, the legal regime for many counterparties in the U.S. is not just "sufficiently certain". It is certain beyond any shadow of a doubt. In April 2005 the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 became law with an effective date in October 2005. Part of this Act is Title IX—the Financial Contract Provisions ("Title IX"). Among other things, Title IX amends the U.S. Federal Deposit Insurance Act (the "FDIA"), which governs insolvency proceedings for most U.S. banks, and the U.S. Bankruptcy Code (the "Code"), which governs insolvency proceedings for corporations and partnerships organised in the U.S.

These amendments to the FDIA and the Code are the product of work done by TBMA and ISDA since 1995. They reflect negotiations between representatives of TBMA and ISDA and the staff of the regulatory agencies represented on the President's Working Group on Financial Markets.¹²

¹² The Working Group's participants for this project included representatives from the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, the Securities and Exchange Commission, the Commodity Futures Trading

Title IX amended the Code to include a new definition of "Master Netting Agreement" and the FDIA to include a new provision stating that any master agreement for transactions including OTC derivatives and SFTs (or any master agreement for one or more master agreements covering OTC derivatives and SFTs) shall be treated as a single agreement. The legislative history for this new provision in the FDIA explains the rationale for its adoption as follows:

"Section 905 of the Act specifies that a master agreement for one or more securities contracts, commodity contracts, forward contracts, repurchase agreements or swap agreements will be treated as a single QFC [qualified financial contract] under the FDIA or the FCUA [Federal Credit Union Act] (but only with respect to the underlying agreements [that] are themselves QFCs). This provision ensures that cross-product netting pursuant to a master agreement, or pursuant to an umbrella agreement for separate master agreements between the same parties, each of which is used to document one or more qualified financial contracts, will be enforceable under the FDIA and the FCUA. Cross-product netting permits a wide variety of financial transactions between two parties to be netted, thereby maximizing the present and potential future risk-reducing benefits of the netting arrangement between the parties. Express recognition of the enforceability of such cross-product master agreements furthers the policy of increasing legal certainty and reducing systemic risks in the case of an insolvency of a large financial participant."¹³

Similarly, the addition of "master netting agreement" to the Code was

"designed to protect the termination and close-out netting provisions of cross-product master agreements between parties. Such an agreement may be used: (i) to document a wide variety of securities contracts, commodity contracts, forward contracts, repurchase agreements and swap agreements, or (ii) as an umbrella agreement for separate master agreements between the same parties, each of which is used to document a discrete type of transaction."¹⁴

It is difficult to imagine stronger or clearer statements of Congressional intent to support the enforceability of broad cross-product netting pursuant to Cross-Product Provisions under the FDIA and the Code.

Moreover, as explained in Appendix C, there is strong legal support for the enforceability of cross-product netting using Cross-Product Provisions in England, France, Germany, Switzerland and Hong Kong.

Commission, and the Department of the Treasury, including the Office of the Comptroller of the Currency. Report of the Committee on the Judiciary of the House of Representatives to Accompany S.256 (the "S.256 Report") Rept. 109-31, at 20 n.79 (April 8, 2005).

¹³ S.256 Report, at 125.

In England, this is a result of a combination of the flawed asset structure of the ISDA Master Agreements and mandatory insolvency set-off rules.

The analysis in France is based upon the provisions of Article 431-7 of the French Monetary and Financial Code. Article 431-7 was introduced in 1993 and has been amended several times since to extend the scope of the recognition of close-out netting under bilateral master agreements where one party is a regulated entity. The most recent improvement occurred on 24 February 2005 with adoption of Ordonnance No. 2005-171, which extended close-out netting to a wide variety of transactions between regulated entities.

In Germany, cross-product netting is not only enforceable in case the netting provisions are triggered before insolvency proceedings have commenced, but Section 104 (2) of the German Insolvency Code also makes netting mandatory once insolvency proceedings have commenced. This mandatory statutory netting regime applies to "financial transactions," which covers the vast majority of OTC derivatives and SFTs.

Under Swiss law there is not any special legislation that recognises cross-product netting across OTC derivatives and SFTs. Switzerland, however, has a strong set-off regime for mutual claims so that cross-product netting is enforceable.

Hong Kong also has a strong statutory set-off regime. Section 35 of Hong Kong's Banking Ordinance as amended in 1996 provides for automatic and mandatory set off on insolvency so that cross-product netting across OTC derivatives and SFTs is enforceable in Hong Kong.

C. Operational Practices

Paragraph 27 of the Consultative Document states that

"industry representatives have indicated that, as a general matter, netting among different types of SFTs for internal risk management is more common than netting between OTC derivatives and SFTs for internal risk management purposes. In this respect, the Revised Framework's 'use test' under Pillar 1 and the supervisory review standards enumerated in Pillar 2 require greater consistency between risk management processes used for internal purposes and those used to meet regulatory capital requirements than is currently practiced with regard to the netting between OTC derivatives and SFTs."

¹⁴ S.256 Report, at 131.

Paragraph 29 then indicates that there will be a consultation among national supervisors to determine when the practice of netting across OTC derivatives and SFTs has reached a sufficient level of usage in the industry as to merit its general recognition for purposes of capital computation. This international consultation is neither necessary nor advisable.

ISDA and TBMA agree that netting among different types of SFTs is more common than netting between OTC derivatives and SFTs for internal risk management purposes. It is not at all surprising that most risk management systems currently do not measure and manage credit risk and calculate capital requirements across all the products covered by a cross-product netting arrangement when cross-product netting is not recognised under the Basel capital rules. Nevertheless, banks and other dealers have developed systems that can readily be adjusted to satisfy the operational criteria set out in paragraphs 103-104 of the Consultative Document. The necessary changes could be done quickly and implemented broadly in the near future, particularly in light of enhanced enforceability due to legal improvements in a number of jurisdictions. It would be unfortunate if the proposed consultation among national supervisors led to a delay in the implementation of these important risk management systems. The length of the proposed consultation process is indefinite and its purpose is not well defined. Moreover, looking to usage "in the industry" fails to provide incentives to individual industry participants to increase the use of cross-product netting and to encourage them to lead the industry in terms of risk management practices. National regulators are well placed to determine when the relevant operational criteria for cross-product netting have been met by an industry participant. Once that has occurred, that industry participant should realize the full benefits of its achievements; it should not be forced to wait for the industry generally to make similar improvements. We emphasize again that capital barriers to the use of enforceable risk management tools have a significant negative impact on market practice and activity.

D. Conclusion

The Consultative Document creates separate product categories for OTC derivatives and SFTs and proposes that netting across these product categories not be recognised for regulatory capital purposes until there has been a supervisory determination that cross-product netting has reached a sufficient level of legal certainty

and usage in the industry. As demonstrated above, this proposal fails to take into account legal developments and documentation and risk management improvements. The 1999 CRMPG report recommended the use of multi-product master agreements and master-masters. In response, a number of market participants have developed their own clauses to link together separate master agreements, and ISDA and TBMA have published documents that facilitate cross-product netting. The national legislatures in the U.S., France, Germany and elsewhere have adopted laws that establish the enforceability of cross-product netting and recognise its importance as a risk management tool both for individual institutions and as a systemic matter. Moreover, jurisdictions such as England, Switzerland and Hong Kong have robust set-off regimes in insolvency that facilitate cross-product netting. Finally, banks and other major dealers have developed risk management systems that can readily be adjusted to manage counterparty risk based upon the effects of cross-product netting. Accordingly, ISDA and TBMA believe that the proposed Cross-Product Netting Rules should be revised to eliminate the requirement in paragraph 95 for an international consultation among supervisors on legal certainty and usage in the industry. Rather, any prior approval requirements should be set individually by national regulators. Elimination of this requirement in paragraph 95 would take into account all the legislative, documentation and risk management progress made to date and promote further progress on legal reform and improvement of documentation, risk management and operational practices.

II. Other Issues

A. The Relationship of the Proposed Cross-Product Netting Rules and Other Netting Rules

The Consultative Document states in paragraph 22 that "[u]nder the provisions of the 1988 Accord, as amended, and the Revised Framework on credit risk mitigation techniques, bilateral netting is recognised for purposes of calculating capital requirements within certain product categories, namely OTC derivatives, repo-style transactions, and on-balance-sheet loans/deposits [footnotes omitted]". In particular, the 1988 Basel Capital Accord (as amended) (the "1988 Accord") permits netting of OTC derivative transactions for purposes of calculating the counterparty risk charge in the banking and trading books if these transactions are subject to a

legally enforceable bilateral netting agreement. The Revised Framework also permits netting of repo-style transactions (which include repurchase/reverse repurchase transactions and securities lending/borrowing transactions) across the banking and trading books if they are subject to a legally enforceable bilateral netting agreement and satisfy certain other conditions. While the legal certainty requirements under these rules are broadly similar, they are not identical.

In that connection, footnote 20 to the "Legal Criteria" heading for the proposed Cross-Product Netting Rules on page 24 of the Consultative Document causes concern. The footnote states that "[t]hese legal requirements apply to all netting agreements recognised for regulatory capital purposes, and not just to cross-product netting agreements". We think that footnote 20 is not consistent with paragraph 156 of the Consultative Document, which states as follows:

"For a bank that qualifies to net transactions, the bank must have internal procedures to verify that, prior to including a transaction in a netting set, the transaction is covered by a legally enforceable netting contract that meets the applicable requirements of the 1988 Accord, as amended, the Revised Framework text on credit risk mitigation techniques, or the Cross-Product Netting Rules set forth in this rule." (Emphasis added.)

Thus, under paragraph 156 in order to include either OTC derivatives or repo-style transactions in a netting set, a bank must verify that the relevant contract satisfies either the 1988 Accord, as amended, or the Revised Framework text on credit risk mitigation techniques. Consequently, we believe that footnote 20 should be deleted. Similarly, the word "and" in the penultimate line of paragraph 101 of the Consultative Document should be replaced with "or".

B. Definition of "Walkaway Clause"

Paragraph 100 states that the legal criteria for cross-product netting include that the "Cross-Product Netting Arrangement does not include a walkaway clause", which is, as in the 1988 Accord, defined as "a provision which permits a non-defaulting counterparty to make only limited payments, or no payment at all, to the estate of the defaulter, even if the defaulter is a net creditor". Experience with this definition of "walkaway clause" has demonstrated that it is too vague. First, although we believe that it was not intended, this definition

could be interpreted to impair the use of contractual set-off clauses. Contractual set-off clauses are often used under individual master agreements to link the amount that may be due as a result of the application of close-out netting under a single master agreement to other amounts due between the same two parties. This type of set-off does, however, permit a non-defaulting party to reduce the amount it may owe under a single master agreement. Similarly, although we again believe it was not intended, master-master agreements also could be viewed as walkaway clauses under the proposed definition in paragraph 100 because they are contractual provisions that permit a non-defaulting party to make a lower payment than it would after close-out netting under a single master agreement. Finally, questions have arisen recently about whether the “flawed asset” provision in the ISDA Master Agreements¹⁵ is a walkaway clause. This provision is an important risk management tool for non-defaulting parties and it is one foundation for the enforceability of close-out netting in England as explained in Appendix C.

In view of this experience, ISDA and TBMA believe that “walkaway clause” should be defined with more precision for all purposes under the Basel capital rules to apply to certain types of results that occur in calculating the close-out amount due after early termination of a single master agreement. This approach was taken recently by the U.S. Congress. Title IX as recently adopted in the U.S. amended the FDIA to add the following provision to Section 11(e)(8) of the FDIA (the provision of the FDIA that defines “qualified financial contracts” such as swap agreements and securities contracts and establishes provisions for early termination and close-out netting of qualified financial contracts with an insolvent depository institution):

"(i) IN GENERAL.—Notwithstanding [the netting provisions in the FDIA for qualified financial contracts and the broad netting provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991], no walkaway clause shall be enforceable in a qualified financial contract of an insured depository institution in default.

(ii) WALKAWAY CLAUSE DEFINED.—For purposes of this subparagraph, the term 'walkaway clause' means a provision in a qualified financial contract that, after calculation of a value of a party's position or an amount due to or from 1 of the parties in accordance with its terms upon termination, liquidation, or acceleration of the qualified financial contract, either does not create a payment obligation of a party or extinguishes a payment obligation of a party in whole or in part solely because of such party's status as a nondefaulting party."

¹⁵ Section 2(a)(iii) of the 1992 ISDA Master Agreement provides in relevant part that a party's payment and delivery obligations are subject to “the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing.”

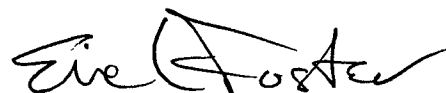
We think that this FDIA provision provides a clear definition of "walkaway clause" that strikes the right balance between concerns that insolvent financial institutions will lose assets and concerns of creditors that they continue to be able to use important contractual protections such as contractual set-off clauses, master-master agreements and flawed asset provisions in master agreements. Accordingly, we believe that paragraph 100 of the Consultative Document should be amended to include a definition similar to the definition of "walkaway clause" that was recently adopted by the U.S. Congress based upon "recommendations issued by the President's Working Group on Financial Markets and revisions espoused by the financial industry".¹⁶

Thank you for the opportunity to comment. We would be pleased to provide any additional information you might require and answer any questions you might have. Please address any requests or questions to Kimberly Summe, the General Counsel of ISDA, at 1-212-901-6030, or Eric L. Foster, Associate General Counsel of TBMA, at 1-646-637-9222.

Very truly yours,



Kimberly Summe
General Counsel, ISDA



Eric L. Foster
Associate General Counsel, TBMA

¹⁶ S.256 Report, at 20.

Appendix A

JURISDICTIONS COVERED BY ISDA'S NETTING OPINIONS

Australia	Hong Kong	Poland
Austria	Hungary	Portugal
Bahamas	India	Scotland
Belgium	Indonesia	Singapore
Bermuda	Ireland	South Africa
British Virgin Islands	Italy	South Korea
Canada	Japan	Spain
Cayman Islands	Jersey	Sweden
Czech Republic	Luxembourg	Switzerland
Denmark	Malaysia	Taiwan
England & Wales	Mexico	Thailand
Finland	Netherlands	Turkey
France	Netherlands Antilles	United States
Germany	New Zealand	
Greece	Norway	
Guernsey	Philippines	

TRANSACTIONS UNDER THE ISDA MASTER AGREEMENTS

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.¹ 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.

¹ Some market participants may refer to credit protection transactions as credit swaps, credit default swaps or credit default options.

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.

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.

EU 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.

Repurchase Transaction. A transaction in which one party agrees to sell securities to the other party and such party has the right to repurchase those securities from such other party at a future date.

Securities Lending Transaction. A transaction in which one party transfers securities to a party acting as the borrower in exchange for a payment or a series of payments from the borrower and the borrower's obligation to replace the securities at a defined date with identical securities.

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.

INTRODUCTION

Set forth below is a summary of the legal analysis supporting the enforceability of cross-product netting in the U.S., England, France, Germany, Switzerland and Hong Kong prepared by Allen & Overy lawyers admitted in those jurisdictions.

The following terms will have the meanings set forth below when used in this Appendix:

"Bridge" means the Cross-Agreement Bridge published by ISDA in 2001.

"Bridged Agreements" means the other master agreements specified by the parties to an ISDA Master Agreement to be covered by a Bridge.

"CPMA" means the Cross Product Master Agreement published by TBMA in 2000.

"Cross-Product Provisions" has the meaning set forth in Part I.A of the letter of which this Appendix is a part.

"GMRA" means the Global Master Repurchase Agreement published by TBMA and the International Securities Market Association in 2000.

"GMSLA" means the Global Master Securities Lending Agreement published by the International Securities Lending Association in 2000.

"ISDA" means the International Swaps and Derivatives Association, Inc.

"ISDA Master Agreement" means either a 1992 ISDA Master Agreement (Multicurrency-Cross Border) or a 2002 ISDA Master Agreement.

"MRA" means the Master Repurchase Agreement published by TBMA in 1996.

"MSLA" means the Master Securities Loan Agreement published by TBMA in 2000.

"OSLA" means the Overseas Securities Lenders Agreement published in 1995.

"OTC derivatives" means all the types of transactions listed in Appendix B to this letter that are not SFTs.

"Principal Agreements" means the bilateral master agreements listed by the parties in a schedule to the CPMA.

"SFTs" means securities financing transactions, including repurchase agreements, securities loans and buy/sell-back transactions.

"TBMA" means The Bond Market Association.

1. U.S. LAW

There are three statutory regimes in the U.S. at the federal level that are relevant to an analysis of bilateral close-out netting across OTC derivatives and SFTs. The Bankruptcy Code (the "Code") governs insolvency proceedings for U.S. corporations and partnerships. The Federal Deposit Insurance Act (the "FDIA") governs conservatorship or receivership proceedings of institutions the accounts of which are insured by the Federal Deposit Insurance Corporation. As a practical matter, the FDIA would govern the insolvency proceeding of all large U.S. banks. The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") provides an overlay protecting close-out netting for a broad category of payment obligations under netting contracts, but only if the netting contract is between two "financial institutions" as defined in FDICIA and regulations adopted thereunder.

As described above in this letter in April 2005 the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 became law in the U.S. Part of this Act is Title IX—the Financial Contract Provisions ("Title IX"). The amendments in Title IX will be effective for insolvency proceedings that commence 180 days or more after April 20, 2005.

1.1 U.S. Law Before Title IX

The status of cross-product netting in the U.S. prior to the passage of Title IX is described in the Allen & Overy Memorandum of Law addressed to ISDA dated November 4, 2003 as updated on December 23, 2004. In brief, under the Code cross-product netting for OTC derivatives and SFTs documented under an ISDA Master Agreement is enforceable subject to a possible delay due to the application of the automatic stay to netting across "swap agreements" (OTC derivatives), "repurchase agreements" (one type of SFT) and "securities contracts" (including other types of SFTs). The Code contains separate protections for early termination and close-out netting of swap agreements, repurchase agreements and securities contracts. For the same issue under the FDIA, OTC derivatives and SFTs all qualify as a type of "qualified financial contract" (QFC) as defined in the FDIA. The FDIA requires that any transfer of QFCs between an insolvent bank and a counterparty (and its

affiliates) include all QFCs between those parties or none of them. While there was a possibility of selective repudiation, the Federal Deposit Insurance Corporation (the "FDIC") issued a policy statement to the effect that the FDIC would apply the same policy to repudiation that the FDIA applies to transfers. As a result, under the FDIA and FDIC policy, transfer or repudiation has involved all QFCs or no QFCs between an insolvent bank and a counterparty (and its affiliates). In the absence of either transfer or repudiation, a counterparty of an insolvent bank in a receivership could terminate and apply close-out netting across OTC derivatives and SFTs.

Cross-product netting under either a Bridge or a CPMA raised additional issues, but the results were similar to those described above. The answers are clearest when the two parties to (1) an ISDA Master Agreement, a Bridge and several Bridged Agreements or (2) a CPMA and several Principal Agreements are both "financial institutions" as defined in FDICIA. In that case, cross-product netting across OTC derivatives and SFTs is enforceable under FDICIA's broad protection for netting of payment obligations under "netting contracts"¹ as defined in FDICIA.

1.2 U.S. Law After Title IX

While the enforceability of cross-product netting in the U.S. was relatively robust prior to the passage of Title IX, there was a possibility of delay under the Code and the need to rely on a FDIC policy statement under the FDIA. Title IX eliminates these concerns and provides true clarity on the enforceability of cross-product netting under the Code and the FDIA. There is no need to consider netting under Cross-Product Provisions developed by an individual institution or under a single ISDA Master Agreement separately from the use of a Bridge or a CPMA because the same basic analysis applies to all four approaches.

(a) The Code

Title IX adds new definitions of "master netting agreement" and "master netting agreement participant" as sections 101(38A) and 101(38B) of the Code, which are designed to protect the termination and close-out

¹ Prior to the passage of Title IX a netting contract under FDICIA needed to be governed by the law of the U.S. or a U.S. state. Title IX removes this governing law limitation.

netting provisions of cross-product master agreements (such as the ISDA Master Agreements) and umbrella agreements for separate master agreements and transaction agreements (such as Cross-Product Provisions developed by an individual institution, the Bridge and the CPMA). Such a cross-product master agreement may be used (i) to document a wide variety of securities contracts, commodity contracts, forward contracts, repurchase agreements and swap agreements or (ii) as an umbrella agreement for separate master or transaction agreements between the same parties, each of which is used to document a discrete type of transaction. The definition of "master netting agreement" clarifies that a master netting agreement will be treated as such for all qualifying transactions even if it documents transactions that are not within the enumerated categories of qualifying transactions. A "master netting agreement participant" is any entity, domestic or non-U.S., that is a party to an outstanding master netting agreement with a debtor before the filing of a bankruptcy petition.

Title IX adds a new section 561 to the Code, under which a master netting agreement and all swap agreements, securities contracts, repurchase agreements, commodity contracts and forward agreements thereunder may be terminated, liquidated or accelerated, and a setoff may be effected in the same way as for other protected categories. This new legal certainty for master netting agreements enhances legal certainty for cross-product netting.

Separate subsections of section 362(b) of the Code currently protect enforcement, free from the automatic stay, of netting provisions in swap agreements, repurchase agreements and securities contracts. There is, however, an issue of whether the automatic stay applies to netting across these protected classes. As a result, the automatic stay could apply to the application of netting across product types, which would delay cross-product netting. Title IX adds section 362(b)(27) to the Code that, together with new Section 561, eliminates this delay risk by stating that the automatic stay does not apply to netting among the various categories of protected transactions.

(b) The FDIA

As discussed above, under current law the FDIC must transfer all QFCs with a counterparty if it transfers any QFCs with that counterparty. Selective transfer is not permitted. Prior law, however, does not expressly bar

selective repudiation by the FDIC. The FDIC has announced that its policy is not to repudiate or disaffirm QFCs selectively. Title IX adds a new section 11(e)(11) to the FDIA that limits the disaffirmance and repudiation authority of the FDIC with respect to QFCs so that such authority is consistent with the FDIC's transfer authority under FDIA section 11(e)(9). This ensures that no disaffirmance, repudiation or transfer authority of the FDIC may be exercised to "cherry-pick" or otherwise treat independently any of the QFCs between a depository institution in default and a person or any affiliate of such person.

Title IX also amends section 11(e)(8)(D)(vii) of the FDIA to state that a master agreement for one or more securities contracts, commodity contracts, forward contracts, repurchase agreements or swap agreements (or any master agreement for one or more master agreements) will be treated as a single QFC under the FDIA (but only to the extent the underlying agreements are themselves QFCs). This provision ensures that cross-product netting pursuant to a master agreement (such as an ISDA Master Agreement or a prime brokerage or customer agreement that contains Cross-Product Provisions), or pursuant to an umbrella agreement for separate master agreements between the same parties (such as Cross-Product Provisions developed by an individual institution, a Bridge or a CPMA), each of which is used to document one or more QFCs, will be enforceable under the FDIA.

2. ENGLISH LAW

We refer to the Allen & Overy memorandum of law addressed to ISDA dated 5 March 2004 on the validity and enforceability under English law of close-out netting under the 2002 ISDA Master Agreements, as updated on 15 November 2004 (the "English Netting Opinion"). The following summary is subject to the assumptions and qualifications in the English Netting Opinion. The assumptions and qualifications are, in our view, straightforward, specific and adequately explained. They do not materially narrow the scope of the conclusions expressed.

In brief, the English Netting Opinion confirms that cross product netting is enforceable under English law, including English insolvency law, without any material reservation, including as between OTC derivatives, on the one hand, and SFTs, on the other hand.

2.1 Cross-product netting of OTC derivatives transactions and SFTs documented under an ISDA Master Agreement

In the English Netting Opinion, we confirm our opinion that the close-out netting provision of the ISDA Master Agreement (Section 6(e)) would be enforceable under English law in the event of insolvency proceedings in England in respect of an English company or in respect of the English branch of a foreign bank. Our opinion confirms that the close out netting would be enforceable in relation to all the types of transactions listed in Appendix B to this letter, which includes both OTC derivatives and SFTs.

In our view, the effectiveness of close-out netting provisions as a matter of contract is based primarily on a "flawed asset" analysis. Payment and delivery obligations in respect of transactions under the ISDA Master Agreement are conditional upon an early termination date not having occurred or been designated (amongst other things). As a result, the parties never have more than a conditional entitlement to receive payments or deliveries. In other words, the "assets" represented by the parties entitlements are flawed by the existence of certain conditions. The ISDA Master Agreement provides that upon the effective designation (or the deemed

occurrence of) an early termination date the obligations of each party in respect of individual transactions cease under Section 6(c)(ii) and instead a single amount becomes payable under Section 6(e). We believe that an English court would recognise and give effect to this flawed asset analysis, to the effect that the parties' obligations under individual transactions are replaced, upon the occurrence or effective designation of an early termination date, by a single net obligation calculated on the basis set out in Section 6(e). This net obligation is a mere accounting and not the result of a set-off of claims determined in respect of those Transactions.

There is a possibility, which we consider remote, that an English court might decide that, upon the commencement of an administration or winding up of an English company, the mandatory insolvency set off rule that applies in relation to administration (Rule 2.85 of the Insolvency Rules 1986) or winding up (Rule 4.90 of the Insolvency Rules 1986), as the case may be, should apply in lieu of giving effect to the "flawed asset" analysis. Each of these set off rules, to the extent it applies, is automatic and mandatory. The effect of the application of either set off rule is to reduce all mutual claims between the relevant insolvent English company and its solvent counterparty to a single net claim.

Each set off rule operates only in relation to matured and unmatured claims and in relation to actual (that is, current, "crystallised", "liquidated" or presently due and payable claims) and contingent claims. It is not necessary, in other words, that in order to fall within either set off rule a claim must be "liquidated" at the time the set off takes effect. The set off effected by either set off rule would therefore include all of the claims arising in relation to transactions of a type described in Appendix B entered into under an ISDA Master Agreement between the English company and its counterparty, including OTC derivatives transactions and SFTs.

The result, therefore, of the application of either the administration set-off rule or the winding up set-off rule would be to reduce to a single net claim all of a counterparty's exposures to an insolvent English company arising out of individual transactions under an ISDA Master Agreement between them, regardless of the type of transaction concerned. Accordingly, cross product netting would be effected as a matter of the operation of English law insolvency law, even in the unlikely event that an English court were not to recognise and give

effect to the “flawed asset” analysis underlying the operation of the ISDA early termination and close out netting provisions.

2.2 Cross-product netting of OTC derivatives and SFTs under a Bridge

The Bridge provides a means of effecting cross product netting by bringing the close out values of transactions entered into under other master agreements within the scope of the close out netting provisions of an ISDA Master Agreement. The Bridge is intended for use with a broad range of industry standard master agreements relating to financial or commodity transactions, including agreements relating to SFTs. These would include:

- (a) in relation to repurchase transactions, the GMRA or the MRA; and
- (b) in relation to securities lending transactions, the OSLA, GMSLA or the MSLA.

In our view, the Bridge has the effect of bringing all the transactions covered by Bridged Agreements within the scope of the “flawed asset” arrangement effected by the early termination and close out netting provisions of the ISDA Master Agreement. Accordingly, for the reasons summarised above, we are of the view that the use of a Bridge would be effective as a matter of English law, including English insolvency law, to effect cross product netting between OTC derivatives entered into under the ISDA Master Agreement and SFTs entered into under one or more Bridged Agreements.

For the reasons given in 1 above, even in the event that an English court were not to recognise and give effect to the “flawed asset” analysis underlying the operation of the ISDA early termination and close out netting provisions, cross product netting of OTC derivatives under an ISDA Master Agreement against SFTs under the Bridged Agreements would be effected as a matter of the operation of English insolvency law.

2.3 Cross-product netting of OTC derivatives and SFTs under a CPMA or Cross-Product Provisions developed by an individual institution

The CPMA has a similar purpose to the Bridge, effecting cross-product netting by bringing within its scope the net close-out amounts due under each of the Principal Agreements specified in the schedule to the CPMA.

These could include an ISDA Master Agreement, the GMRA, the MRA, the OSLA, GMSLA and/or the MSLA, and therefore the CPMA may be used to effect cross-product netting of OTC derivatives and SFTs.

In contrast to the Bridge, which relies for its effectiveness on the "flawed asset" arrangement effected by the early termination and close-out provisions of the ISDA Master Agreement, the CPMA effects a contractual set-off of the net close-out amounts due under each Principal Agreement. This is effective prior to the insolvency of a party as a matter of contract under English law. Following the commencement of administration or winding up proceedings in relation to the party in England, cross-product netting under the CPMA will be achieved by operation of the set-off rules under English insolvency law for the reason given in 1 above.

A similar set-off analysis would apply to Cross-Product Provisions developed by an individual institution.

3. FRENCH LAW

Cross-product netting between, on the one hand OTC derivatives and, on the other hand, SFTs has been recognised under French law for a long time, whether such transactions are documented under a single master agreement or under multiple master agreements.

Within the context of a single master agreement, the provisions of Article 431-7 of the French Monetary and Financial Code recognise the enforceability of close-out netting across a wide range of products, including OTC derivatives and SFTs. This legislation, which was first introduced in 1993, has been amended several times since then to extend the scope of the recognition of close-out netting. Since the law no. 96-597 of 2 July 1996, the close-out netting regime applies to "transactions on financial instruments", a broad category which includes any types of OTC derivatives which are typically documented under the 1992 or 2002 ISDA Master Agreements, as well as SFTs. Thus, Article 431-7 allows close-out netting across transactions on any kind of financial instruments, provided that at least one of the parties to such transactions is a regulated¹ entity and irrespective of whether one of the parties is subject to bankruptcy proceedings.

The law no. 2001-420 of 15 May 2001 introduced the so-called concept of "global netting" in the French netting regime, thus allowing cross-product netting across multiple master agreements. Article 431-7 has then been amended in order to extend the benefits of close-out netting to transactions on financial instruments documented under several master agreements, provided that the relevant transactions were documented under industry standard documentation such as the ISDA Master Agreements, the GMRA, the OSLA or the GMSLA. In this way, transactions on financial instruments (including OTC derivatives and SFTs) documented under different standard master agreements could be terminated and the corresponding debts and claims netted, notwithstanding the insolvency of a French counterparty.

¹ For the purposes of Article L.431-7 of the French Monetary and Financial Code, these regulated entities include banks, other financial institutions, insurance companies, investment funds and several other types of entities, whether or not incorporated in France.

The French close-out netting regime has been further amended recently by the Ordonnance no. 2005-171 of 24 February 2005 (the "Ordonnance"). The Ordonnance now extends the benefits of the above close-out netting regime to situations where the relevant transactions are not documented under a recognised standard master agreement. The parties are no longer required to use industry standard documentation or to refrain from amending the so-called "general principles" of such standard documentation.

Finally, the Ordonnance also extends the regime of close-out netting to any transactions (i.e. not only "transactions on financial instruments") giving rise to a cash settlement or to the delivery of financial instruments when the relevant transactions are entered into between parties which are all regulated entities (as defined above). Thus, when the parties are such regulated entities, any kind of transactions which contemplate the payment of cash or the delivery of financial instruments, whether financial transactions or more generally commercial transactions, and irrespective of the way they are documented, will be able to take full advantage of close-out netting on a cross-product basis.

The enforceability of the cross-product netting has thus been recognised and successfully extended in France for over a decade. There is no doubt today that it applies across a wide range of products (including OTC derivatives and SFTs), whether these are documented under a single master agreement or other forms of Cross-Product Provisions.

For your information, we attach an English translation of the relevant provisions of Article 431-7 of the French Monetary and Financial Code, as amended by the Ordonnance.

L.431-7

"The provisions of this section apply to:

1° Financial obligations resulting from transactions on financial instruments when none of the parties are natural persons and when at least one of the parties to the relevant transaction is a credit institution, an investment services provider, a public establishment, a local authority, an institution, a person or an entity which benefits

from the provisions of Article L. 531-2, a clearing house, a non-resident entity with a comparable status, or an international financial organisation or organism of which France or the European Union is a member;

2° Financial obligations resulting from any contract giving a right to cash settlement or to a delivery of financial instruments when all the parties belong to the above-mentioned category of persons, except those who are mentioned in paragraphs c to i of Article L. 531-2-2°;

3° Financial obligations resulting from any contract entered into within the framework of a system mentioned in Article L. 330-1.

II. - Agreements relating to financial obligations mentioned in I above may be terminated and the corresponding debts and claims may be netted. The parties may provide for the calculation of a single settlement amount, whether these financial obligations are governed by one or several agreements or master agreements.

III. - The procedures for the termination, valuation and netting of the transactions and obligations referred to in I and II above are effective vis-à-vis third parties. These procedures may be provided for in agreements or master-agreements. Any termination, valuation or netting effected on grounds of civil enforcement proceedings or pursuant to the exercise of an opposition right will be deemed to have taken place prior to the said proceedings".

4. GERMAN LAW

We have been asked to advise on the enforceability of cross-product netting arrangements under German law in connection with the four methods to document cross-product netting described in Part 1.A of the letter of which this Appendix is a part.

We confirm that under all four methods the inclusion in the netting arrangement of both OTC derivatives and SFTs (as opposed to the use of separate netting arrangements with respect to these two categories of products) does not affect the enforceability of the netting under German law.¹

The enforceability of contractual netting arrangements under German law depends on the assumption that the operation of the relevant contractual netting provision is triggered before the opening of insolvency proceedings with respect to the German counterparty and therefore applies before mandatory provisions (including a statutory netting provision) under the German Insolvency Code apply. (In order to ensure that this is the case, it is recommended that parties specify provisions to the effect that early termination and netting occurs automatically upon the filing of a petition for the opening of insolvency proceedings with respect to a German counterparty.)

If this pre-condition is met, it is immaterial whether the transactions covered by the contractual netting arrangement include both OTC derivatives and SFTs or one of these two categories of products only.

If the operation of the contractual netting provision is not triggered before the opening of insolvency proceedings with respect to the German counterparty, a statutory netting provision under § 104 (2) Insolvency Code applies if two conditions are met.

¹ We refer to the opinion dated 10 December 2004 provided to ISDA by Hengeler Mueller (the German Netting Opinion). Our advice is subject to the qualifications and assumptions contained in that opinion.

First, the individual transactions must be financial transactions which have a market or exchange price and which are due to be performed at a certain time or within a certain period of time. The vast majority² of all OTC derivatives as well as SFTs qualify as financial transactions for purposes of § 104(1) Insolvency Code.

Second, the master agreement (which depending on the method of documentation would be the ISDA Master Agreement, the ISDA Master Agreement including the Bridge or the CPMA) must be a master agreement which provides that the transactions can only be terminated together if a ground for opening insolvency proceedings exists. Under all four methods referred to above, it is easy to specify appropriate standard language to ensure that all transactions covered can only be terminated together if a ground for opening insolvency proceedings exists.

The fulfillment of neither of these two requirements of § 104(2) Insolvency Code (i.e. the statutory netting provision) would be adversely affected by the fact that the netting arrangement includes both OTC derivatives and SFTs (rather than only one of these two categories of products).

² For a discussion of some very limited exceptions (which have nothing to do with the cross-product or single-product nature of the netting arrangement), see page 42 of the German Netting Opinion. Specifically with respect to SFTs, we believe that such transactions are unlikely to be recharacterized as secured cash loans for purposes of § 104(2) Insolvency Code since the official reasoning of the last revision of § 104(2) Insolvency Code expresses a clear intention to include such transactions in the application of § 104(2) Insolvency Code. In the unlikely event that SFTs were to be nevertheless recharacterized as secured cash loans, the effect would be that the contractual netting would be applied (see pages 49 and 50 of the German Netting Opinion).

5. SWISS LAW

From a Swiss law viewpoint, cross-product netting between OTC derivatives and SFTs does not raise any particular legal concerns. However, the analytical approach to cross-product netting will depend on whether all transactions to be netted are documented by an ISDA Master Agreement or whether the transactions are documented by different master agreements such as an ISDA Master Agreement, a GMRA, an OSLA or a GMSLA.

5.1 All transactions documented by an ISDA Master Agreement

Where all the transactions to be netted are documented by an ISDA Master Agreement, the cross-product netting under Section 6 of the ISDA Master Agreement between any of the transactions listed in Appendix B to this letter will be valid and enforceable in the insolvency of a Swiss counterparty as set out in the Memorandum of Law on the enforceability under Swiss law of the termination, close-out and multibranch netting provisions of the 1987 and 1992 ISDA Master Agreements and the ISDA 2002 Master Agreement prepared by Dr. Thomas Werlen (the "Memorandum of Law").

In any event, as explained in the Memorandum of Law, it is desirable from a Swiss law viewpoint to opt under the ISDA Master Agreement for automatic early termination to apply in respect of the Swiss counterparty.

5.2 Netting between transactions documented by different Master Agreements

Where the transactions to be netted are documented by different Master Agreements such as an ISDA Master Agreement, the GMRA (for repurchase transactions) or the OSLA or the GMSLA (for securities lending transactions), cross-product netting between OTC derivatives and SFTs across different master agreements will require that the parties enter into a netting arrangement that takes into account the different master agreements such as the Bridge or the CPMA or another agreement on cross-product netting containing Cross-Product Provisions.

Assuming that the termination and close-out netting of transactions entered into under each master agreement is valid and enforceable, the cross-product netting between the net amounts determined for each master agreement can take place in different forms: (i) the Bridge provides for the net amounts determined for each Master Agreement to be included into the netting under the ISDA Master Agreement as if it was a transaction under the ISDA Master Agreement, whereas (ii) the CPMA provides for the net amounts determined for each master agreement to be set off against one another.

To the extent the Bridge is used, this does not affect the conclusion that the netting under the ISDA Master Agreement is valid and enforceable from a Swiss law viewpoint as set out under (1) above.

Where the parties use the CPMA or another netting arrangement that provides for a set-off of net amounts, this does not raise any particular problems in the insolvency of a Swiss counterparty in addition to the issues discussed in the Memorandum of Law for the validity and enforceability of netting arrangements even though there is no special legislation in Swiss insolvency law that recognizes the set-off of claims across different products in the derivatives and securities markets. As a matter of principle, a set-off of debts of the bankrupt debtor with mutual claims the debtor has against the creditor is enforceable in the bankruptcy of the debtor. The adjudication of bankruptcy causes the maturity of the debts of the bankrupt debtor (Art. 208 of the Federal Act on Debt Enforcement and Bankruptcy (the "Bankruptcy Code")). However, the set-off of mutual debt obligations requires that (i) at the time the debtor is declared bankrupt or a payment moratorium (*Nachlassstundung*) is published, the debtor of the bankrupt is also his creditor (Art. 213 of the Bankruptcy Code), and (ii) such creditor has not acquired his claim against the bankrupt in order to gain an undue advantage by way of set-off (Art. 214 of the Bankruptcy Code).

5.3 Conclusions

Under Swiss law, cross-product netting is enforceable in the insolvency of a Swiss counterparty whether the transactions have been documented only under an ISDA Master Agreement or whether they have been documented under different master agreements. Where the parties have documented the transactions under

different master agreements, we assume, however, that they also have entered into an additional netting arrangement such as the Bridge, the CPMA or a similar agreement that contains Cross-Product Provisions.

6. HONG KONG LAW

We refer to the Allen & Overy memorandum of law on the validity and enforceability under the laws of the Hong Kong Special Administrative Region ("HKSAR") of the People's Republic of China dated 15th January, 2004 and updated on 15th December, 2004 (the "HKSAR Opinion"). The assumptions and qualifications in the HKSAR Opinion are deemed to be incorporated into this letter as if expressly set out herein. The assumptions and qualifications are, in our view, straightforward, specific and adequately explained. They do not materially narrow the scope of the conclusions expressed.

In sum, the cross-product netting provisions in the ISDA Master Agreement and the cross-product and cross-agreement netting provisions in the Bridge, the CPMA and Cross-Product Provisions developed by an individual institution would be effective on the insolvency of a HKSAR company

6.1 All transactions documented by an ISDA Master Agreement

On the occurrence of a designation of an Early Termination Date under an ISDA Master Agreement, no further payments are required to be made with respect to the terminated transactions and the only amounts payable will be the net amounts determined by Section 6(e) of the ISDA Master Agreement.

As expressed in the HKSAR Opinion, where an early termination date has been designated as a result of an event set out in Section 5(a)(vii) (Bankruptcy) of an ISDA Master Agreement, the netting provisions of Section 6(e) of the ISDA Master Agreement would be valid on the insolvency of a HKSAR company when considered on the basis of insolvency set-off.

Section 35 of the Bankruptcy Ordinance Cap. 6, as amended by the Banking (Amendment) Ordinance 1996 (together, the BO), provides for automatic and mandatory set off on insolvency¹. It is clear under HKSAR law that where two corporate parties have had mutual dealings prior to the date of the winding-up order of one of the parties, the solvent party may prove in the liquidation for the net sum due by the insolvent party after setting off all sums due to the insolvent on the date of the winding-up order, including debts which are contingent at that date: In *Re First Bangkok City Finance* the Hong Kong Supreme Court held that the object of section 35 of the BO is to do justice between the parties and to avoid a creditor of an insolvent company being required to make payment in full to the liquidator and being only able to prove for a dividend in the liquidation for his own debt. Where the relevant termination or close-out of transactions (including, SFTs and OTC derivatives) under the ISDA Master Agreement occurs on or before the date of the winding-up order, the close-out netting provisions (under which various types of SFTs and OTC derivatives are netted against each other) will be enforceable under HKSAR law as they essentially provide for an identical measure of set-off as the mandatory statutory insolvency provisions themselves.

Under HKSAR law, insolvency set-off is available even though the claims are not liquidated or are not connected with each other. It is not necessary that the claims arise out of similar transactions. Consequently, cross-product netting between OTC derivatives and SFTs is enforceable on the insolvency of a HKSAR company and is mandatory. That is, on the insolvency of a HKSAR company, the termination values of all terminated transactions (which would include SFTs and OTC derivatives) will be automatically set-off under Section 35 of the BO and it is not possible to contract out of such set-off.

6.2 Netting between transactions documented by different Master Agreements

As set out above, on the insolvency of a HKSAR company, section 35 of the BO will automatically apply to set off all mutual amounts (including contingent amounts) owing by or to such insolvent HKSAR company and its counterparty. Consequently, the cross-agreement netting achieved by the Bridge, the CPMA or Cross-Product Provisions developed by an individual institution would be valid on the insolvency of a HKSAR company as a

¹ Section 35 of the BO applies to the insolvency of companies by virtue of section 264 of the Companies Ordinance Cap. 32.

result of the mandatory and automatic set-off under the BO. Even in the absence of Cross-Product Provisions, the net amount due under each master agreement would be set off (and any other amounts due between the parties) as a result of the BO.