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Master OTC Options Agreement

Guidance Notes

2000 Version

In connection with its ongoing project to create and update standardized agreements for use in securities transactions, The Bond Market Association (the "Association") is publishing a revised version of its Master OTC Options Agreement (the "Agreement"), which was last amended in August 1989.[1] These Guidance Notes are designed to assist parties in using this Agreement and in arranging transactions under the Agreement. They do not form part of the Agreement.

The revisions to the Agreement are designed to reflect a number of important legal and marketplace developments since the last amendments, while at the same time preserving the key features of the 1989 version of the Agreement that have led to its widespread acceptance by market participants. As in the past, the Agreement will continue to provide, on a reciprocal basis, the basic legal protections that are essential for market participants, including default remedies and standard provisions for the delivery of and payment for securities covered by the Agreement. The Agreement has been refined, however, to reflect user experience with its provisions and has been updated in the following significant respects —

Broadening of Scope. The Agreement has been revised to cover options on a broader range of securities than simply the U.S. Treasury securities which could be Underlying Securities under the August 1989 agreement. Although the Agreement is designed principally to be used in connection with options on U.S. Treasury, agency and agency mortgage-backed securities, it has been modified to allow the parties to designate, through the use of Annex I or a Confirmation, additional types of securities as permissible Underlying Securities. In addition, the Agreement may also now be used for transactions between dealers and non-dealer counterparties.

Legal Developments. The Agreement has been revised to incorporate a number of changes that reflect market participants' experience in exercising liquidation and similar closeout rights in the context of counterparty insolvency. In addition, the Agreement has been amended to address changes to Article 8 of the New York Uniform Commercial Code and other applicable laws.

Harmonization with Other Agreements. The Agreement has generally been harmonized with other master agreements published or sponsored by the Association. The drafters of the Agreement have generally conformed the structure and language of the Agreement with that of other Association-published or sponsored master

[1] The 1989 version of the Agreement is entitled "Master Dealer Agreement, OTC Option Transactions—U.S. Treasury Securities."

agreements, notably the Master Repurchase Agreement (September 1996 version), the Master Securities Forward Transaction Agreement and the Cross-Product Master Agreement.

International Transactions Annex. An optional Annex IV has been prepared for use with Options that involve non-U.S. parties and/or Underlying Securities.

Agency Annex. An optional Annex V has been prepared for use with Options where a party is acting as agent for one or more disclosed principals.

The Association wishes to emphasize that the publication of the revised Agreement should not be construed as a suggestion that counterparties no longer conduct business pursuant to the 1989 version of the Agreement. Nevertheless, the Association views the revised Agreement as better suited to current market conditions than the 1989 version and strongly encourages its use in establishing new counterparty relationships. The Association does not, however, consider it necessary for counterparties to abandon existing contractual arrangements based on the 1989 version absent a mutual determination that the revised Agreement would be preferable.

The Agreement has been prepared as a standard form and any person proposing to use it should ascertain that it is suitable for the circumstances in which it is proposed to be used. The Association does not assume responsibility for use of the Agreement or any Annex or Schedule in any particular circumstance. Parties using this documentation may wish to incorporate amendments. The Association, however, will only permit this documentation to be used in an amended form if the amendments are made is such a way that they are clearly identifiable (for example by a side letter or mark-up).

To assist users of the Agreement, the Association has prepared the following guidance notes to explain and summarize on a section-by-section basis the key elements of the Agreement. ***These guidance notes should not be relied upon by any party to determine, without appropriate legal, accounting or other relevant professional advice, whether the Agreement is suitable to its particular circumstances and needs.*** Capitalized terms not otherwise defined have the meanings given to them in the Agreement.

Paragraph 1: Applicability

Paragraph 1 delineates the general scope and applicability of the Agreement. The Agreement applies to all transactions between the parties in which over-the-counter options are written on "Underlying Securities," except transactions documented pursuant to a written confirmation that references a master agreement other than the Agreement. "Underlying Securities" are defined as instruments that are either (i) direct obligations of, or obligations guaranteed as to principal or interest by, the United States, (ii) securities issued or guaranteed by a corporation in which the United States has a direct or indirect or indirect interest, or (iii) such other instruments as are specified in a Confirmation or in Annex I. Clauses (i) and (ii) use the same language as the exemption contained in Rule 3a12-7 promulgated under the Securities Exchange Act of 1934 and are intended to cover all securities currently covered by that

exemption. Each such transaction is referred to in the Agreement as an "Option." Unless otherwise agreed in writing, all Options are governed by the terms and conditions of the Agreement, including any Annexes thereto.

The Association recommends that parties not use the Agreement to document Options on Underlying Securities other than U.S. Treasury, agency, and agency mortgage-backed securities without carefully reviewing the Agreement to determine whether supplemental provisions are necessary to accommodate Options on such Underlying Securities. Parties that choose to use Annex I to expand the scope of the Agreement should be aware that the Agreement is drafted primarily for options on U.S. Treasury, agency and agency mortgage-backed securities and may require modification for Options on securities that trade differently or in less liquid markets. In particular, parties entering into Options on Underlying Securities not exempted by Rule 3a12-7 under the Securities Exchange Act of 1934 (the "Exchange Act")[2] should be aware that the offer and sale of such Options may need to be registered with the Securities and Exchange Commission. Additional issues that parties using the Agreement for Options on Underlying Securities other than U.S. Treasury, agency and agency mortgage-backed securities may wish to consider include other securities law issues such as compliance with margin regulations and "private placement" restrictions. Parties that use the Agreement to document options on Underlying Securities other than U.S. Treasury, agency and agency mortgage-backed securities, whether fixed income or equity securities, should also consider the extent to which it will be necessary to override the Agreement's presumptions with respect to automatic exercise, as well as to modify the definitions of Business Day, Exercise Value, Settlement Date, Exercise Hours, Close of Trading and, if applicable, the method of determining Market Value in the Performance Assurance Annexes.

Although the Agreement may be used to document Options between dealers and non-dealer counterparties, parties entering into such transactions with non-dealer counterparties should consider carefully whether additional provisions are necessary. In particular, the parties should add appropriate representations and warranties to Annex I in cases where one or more of them is a registered investment company under the Investment Company Act of 1940.

Paragraph 2: Definitions

The definitions in Paragraph 2 cover the principal recurring terms used throughout the Agreement.

Act of Insolvency

The language of this definition mirrors that in the Master Repurchase Agreement and the Master Securities Forward Transaction Agreement, and encompasses those events typically considered to be clear indications of a party's inability to perform. The

[2] Rule 3a12-7 specifies certain categories of derivative securities that qualify as "exempted securities" under Section 3(a)(12) of the Exchange Act, including certain OTC options on U.S. Treasury, agency and agency mortgage-backed securities.

occurrence of an Act of Insolvency is an Event of Default under Paragraph 8 of the Agreement.

Business Day, Close of Trading, Exercise Hours, Exercise Value, Premium Payment Date and Settlement Date
These definitions reflect the applicability of the Agreement to Options on U.S. Treasury, agency and agency mortgage-backed securities and generally refer to days on which the Federal Reserve Bank of New York and the government securities markets are open for business, and to New York time. Parties that expand the definition of "Underlying Securities" beyond these securities should consider whether these definitions require modifications in those circumstances.

The definitions of Exercise Hours and Close of Trading (both of which relate to the definition of Expiration Date) also cover situations in which the principal market for purchases and sales of the Underlying Securities closes early, whether or not the early closing is scheduled. The 1989 version of the Agreement does not address early closes.

Collateral and Option Collateral
If a party ("Pledgor") is obligated to pledge "Option Collateral" to the other party pursuant to any Annex, then it also pledges, pursuant to Paragraph 4 of the Agreement, other property in the Pledgee's possession or control (together with the Option Collateral, the "Collateral"). Paragraph 8 of the Agreement gives the Pledgee remedies upon an Event of Default in respect of all Collateral.

Expiration Date
If the parties select an Expiration Date that is not a Business Day or that is unexpectedly not a Business Day (e.g., due to an emergency), the Agreement provides that the Expiration Date shall be the next following Business Day. This clarifies a possible ambiguity in the 1989 version of the Agreement.

Notice of Exercise
A definition of Notice of Exercise has been added to limit the appropriate means of notification of the exercise of an Option to telephonic notice, or such other means of notification as the parties may agree.

Paragraph 3: Initiation and Confirmation

Paragraph 3 describes the mechanics of initiating and confirming an Option. The Agreement contemplates that either party may initiate an Option and that one or both parties (depending typically on whether the Option is between a dealer and a customer or between two dealers) shall promptly deliver a Confirmation of the Option. The Agreement permits the parties to initiate and agree to the terms of an Option electronically, as well as orally or in writing, although the parties may wish to specify whether, and on what terms, Options may be initiated and agreed to through electronic means.

Parties may wish to specify in Annex I who will be confirming Options, how promptly delivery of a Confirmation and any objection thereto must be made, and any other information that should be set forth in the Confirmation in addition to the terms specified in Paragraph 3. If both parties will be confirming Options, they may find it useful to establish a rule of precedence to govern occasions in which their respective Confirmations contain inconsistent terms.

Paragraph 3(b) clarifies that, in the case of a conflict between the terms of a Confirmation and the Agreement (which includes any annexes thereto), the Agreement will prevail unless Annex I or the relevant Confirmation expressly states otherwise. This approach is meant to address all inconsistencies between the Agreement and the Confirmation, including inconsistencies stemming from terms that have been added to the Confirmation by hand or otherwise.

Paragraph 3(c) allows the Writer of an Option to treat such Option as void if the Writer has not received the premium for such Option on or before the Premium Payment Date. This provides an alternative to treating a failure to pay premium when due as an Event of Default.

Paragraph 4: Security Interest

Paragraph 4 provides that if a party is obligated to pledge Option Collateral pursuant to Annex III or IIIa of the Agreement, it also grants the other a first priority security interest in such Option Collateral and any other Collateral, in each case as security for the Pledgor's obligations under the Agreement. The Agreement requires that the parties affirmatively choose whether Retransfer of Collateral by the Pledgee will be permitted. If the parties do not affirmatively choose, Retransfer is deemed to be permitted. "Retransfer" is defined broadly to include the pledge, loan, hypothecation, sale or transfer of any Collateral. Parties to the Agreement should carefully consider any tax, accounting, credit and other issues that could arise from permitting Retransfer of Collateral.

Paragraph 5: Exercise of Options

Paragraph 5 sets forth the mechanics for the exercise of options as well as the obligations arising from exercise. Notice of exercise must be given on or before the Expiration Date of the Option to the party identified in Annex II by telephone or such other means of notification specified by the parties in Annex I or in a Confirmation. Notice of the exercise of a European Option given before the Expiration Date is irrevocable when given, with exercise effective on the Exercise Date.

Paragraph 5(b) provides for physical settlement of Options; parties who wish to provide for cash settlement should include appropriate provisions in Annex I.

Paragraph 5(c) provides for automatic exercise of Options under certain conditions. As a threshold matter, automatic exercise will not take place unless one party to the option gives the other notice, by any means specified in the definition of Notice of

Exercise, no later than one hour after the opening of Exercise Hours (10:00 A.M. New York time), on the Business Day following such Option's Expiration Date. The automatic exercise provisions generally reflect market practice with respect to options on U.S. Treasury securities between dealer counterparties, and parties entering into other types of Options may wish to consider modifying these provisions accordingly.

Paragraph 6: Payment and Transfer

Paragraph 6 sets forth the manner in which securities and funds are to be transferred. Unless otherwise agreed, all payments are to be made in immediately available funds and each exercised Option is to be settled on a delivery-versus-payment basis. Underlying Securities or Collateral consisting of "financial assets" are to be transferred in suitable form for transfer, by physical delivery of certificated securities, registration of uncertificated securities in the transferee's name, a credit to a securities account maintained by the transferee with a securities intermediary or any other mutually agreeable method. The parties may wish to provide delivery instructions in Annex I or Annex II to the Agreement.

This Paragraph also requires each party to conform to market practice for a particular type of Underlying Security, including the provisions of the *Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities*, provided that such market practice does not conflict with any express terms of any Option as agreed between the parties thereto.

The parties should be aware of, and should take appropriate steps to ensure compliance with, any applicable margin regulations, including Regulation T of the Board of Governors of the Federal Reserve System, New York Stock Exchange Rule 431 and Rule 2520 of the National Association of Securities Dealers.

Paragraph 7: Representations

This Paragraph sets forth basic representations to be made by both parties concerning the authority and ability of the parties to enter into the Agreement and any Options thereunder and to perform any obligations that arise with respect thereto. The parties are deemed to repeat the representations as of the Trade Date and the date of exercise of any Option. The Paragraph requires disclosure of a party's status as an agent whenever it is not acting as a principal, and provides for the possibility that parties may wish to utilize Annex V for Options where a party is acting as agent for one or more disclosed principals. Additional representations may be included in Annex I.

Paragraph 8: Events of Default

Paragraph 8 specifies four Events of Default, which can be summarized as follows:

(i) the failure to perform on the Settlement Date or to pay the premium on the Premium Payment Date;

(ii) the occurrence of an Act of Insolvency;

(iii) the making of a material misrepresentation; and

(iv) the admission by a party of its inability or intention not to perform its obligations under the Agreement.

The parties may add other Events of Default in Annex I, and Annexes III and IV contain additional Events of Default in connection with performance assurance arrangements and International Transactions.

It should be noted that as with other Association-published agreements, the Agreement (other than Annex IIIa) does not include a cross-default provision covering a party's default with respect to any other financial transactions between the parties. Parties who desire such a provision should consider entering into a Cross-Product Master Agreement for bilateral cross-default provisions or Annex IIIa for unilateral cross-default provisions.

No notice to the defaulting party or cure period is required in order for the nondefaulting party to declare an Event of Default (although, as described below, Paragraph 8(a) does require the nondefaulting party to notify the defaulting party of such a declaration after it has been made). This lack of any pre-default notice or cure period has been made because market participants have found notice requirements to be a potential obstacle to the swift exercise of their rights where a default occurs in the context of an impending Act of Insolvency.

The default provisions of Paragraph 8(a) give the nondefaulting party the option to declare an Event of Default. The notice provision (Paragraph 10) is intended to make clear that, while the nondefaulting party is required to give notice as promptly as practicable of its declaration of an Event of Default, its inability to do so (e.g., as a result of a failure by the defaulting party to answer its telephones or maintain other lines of communication) will not preclude the immediate exercise of the nondefaulting party's rights. Furthermore, this option is automatically deemed to be exercised immediately and the notice requirement does not apply upon the occurrence of an Act of Insolvency.

The Agreement grants the nondefaulting party several remedies upon an Event of Default. Under Paragraph 8(a), the nondefaulting party may (i) close out one or more Options under the Agreement, whereupon the defaulting party is liable to the nondefaulting party for any resulting loss, damage, cost and expense, including damages equal to the cost of entering into replacement transactions (whether or not actually entered into), (ii) set off any obligations it has to the defaulting party against any obligations the defaulting party has to it under the Agreement, (iii) sell in a recognized market (or otherwise in a commercially reasonable manner) any non-cash Collateral and apply the proceeds to the obligations of the defaulting party under the Agreement or, in its sole discretion, elect to give the defaulting party credit for any Collateral and (iv) take any other necessary or appropriate action to protect and enforce its rights and preserve the benefits of its bargain. Subsection 8(a)(iv) is intended to permit a nondefaulting party that holds a call to purchase (or a nondefaulting party that holds a put to sell) the relevant Underlying Securities in the market in order to preserve the benefits of its position.

Paragraph 8(b) addresses the situation where the defaulting party is the Pledgee of Collateral, and requires the defaulting party to transfer any Collateral held by it to the nondefaulting party upon an Event of Default; the nondefaulting party may purchase Replacement Securities in the event that any Collateral is not so transferred.

Paragraph 8(c) provides that the defaulting party is liable to the nondefaulting party for reasonable legal or other expenses incurred by the nondefaulting party in connection with an Event of Default, damages equal to the cost (including fees, expenses and commissions) of entering into replacement transactions and entering into or terminating hedge transactions, and any other loss, damage, cost or expense directly arising or resulting from the occurrence of an Event of Default in respect of an Option, regardless of whether the nondefaulting party enters into or terminates, as the case may be, any such replacement or hedge transaction. Although the Agreement does not explicitly provide for purchases of Underlying Securities by the nondefaulting party, Subsections 8(a)(iv) and 8(c) are intended to permit the nondefaulting party to purchase Underlying Securities at the defaulting party's expense.

Paragraph 8(d) provides for default interest at the Prime Rate on all amounts owed by the defaulting party.

Paragraph 8(e) provides that, unless otherwise agreed by the parties, any securities included in the Collateral are instruments traded in a "recognized market," and that, in the absence of a generally recognized source for prices or bid or offer quotations for any securities Collateral or Underlying Securities, the nondefaulting party is entitled in its sole discretion to establish a source. It also provides that all prices, bids and offers shall be determined together with accrued principal and/or interest thereon, except to the extent contrary to market practice with respect to the relevant securities (e.g., Government National Mortgage Association securities).

Finally, Paragraph 8(f) affords the nondefaulting party all the rights and remedies provided to a secured party under the New York Uniform Commercial Code (whether or not the NYUCC would otherwise be applicable) and any other rights under any other applicable law or agreements.

Paragraph 9: Single Agreement

This paragraph clarifies that all Options the parties enter into under the Agreement constitute a single business and contractual relationship. Thus, the parties may set off claims and net payments, deliveries and other transfers in respect of any one Option against all other Options under the Agreement.

Paragraphs 10-14: Miscellaneous

Paragraphs 10 through 14 contain standard provisions on a variety of matters typically included in OTC options agreements, which generally conform to the provisions of other Association standard agreements.

Paragraph 10 provides for notices (other than a Notice of Exercise or a notice that can only be given by means permitted for a Notice of Exercise) to be given by telephone, mail, facsimile, e-mail, electronic message, telegraph, messenger or otherwise, and for such notices to be deemed effective on the day on which received or, if not received, when delivery was attempted in good faith. Telephonic notice (other than a Notice of Exercise or a notice that can only be given by means permitted for a Notice of Exercise) must be confirmed in writing and will be effective only if at least one other specifically listed means of notice has been attempted. Parties should, in providing notice, give due consideration to evidentiary issues which may be raised by such notice in any judicial proceedings. As revised, the Agreement no longer provides that a notice received on a date on which the recipient is closed for business shall be deemed received on the next day on which such party is open for business.

Paragraph 11 establishes that the Agreement generally governs all transactions between the parties in which over-the-counter options are written on Underlying Securities as described in Paragraph 1, except where the parties enter into a written confirmation that references a master agreement other than the Agreement. In addition, to the extent that the parties to the Agreement are members of a clearing organization or other entity that has rules that by their own terms apply to the Options and supersede any provisions in the Agreement, it is intended that such rules would prevail over any inconsistent provisions of the Agreement.

Paragraph 13 provides for the application of New York law based upon a determination that, among the numerous available U.S. jurisdictions, the greatest percentage of OTC options transactions occur within it and it has a highly developed body of commercial and securities law.

Paragraph 15: Use of Employee Plan Assets

This Paragraph contains only those provisions that the Association views as essential in light of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). Because there are a variety of prohibited transactions and exemptions therefrom that might apply if one of the parties is a Plan Party, depending on the exact nature of the Option, the Association does not feel that more specific provisions are useful in this general Agreement. Some parties may find the inclusion of additional provisions relating to ERISA desirable under some circumstances and are invited to include any such provisions in Annex I.

Paragraph 16: Intent

This Paragraph makes clear the parties' intent in respect of the rights of the parties under various federal statutes in the context of a bankruptcy or other default. Paragraph 16(a) provides that Options are intended to fall within the Bankruptcy Code definition of a "securities contract," and Paragraph 16(b) provides that a party's remedies in an Event of Default constitute a contractual right to liquidate the Option, as defined in the Bankruptcy Code.

Paragraph 16(c) confirms the parties' understanding that, if one or both of them is an "insured depository institution" (as defined in the Federal Deposit Insurance Act ("FDIA")), then each Option is a "qualified financial contract" (as defined in FDIA). This provision is intended to assist parties involved in Options with an insured depository institution in obtaining the benefits of FDIA protections applicable in the event that the Federal Deposit Insurance Corporation is appointed conservator or receiver.

Finally, Paragraph 16(d) confirms the parties' understanding that, if they are both "financial institutions" (as defined in the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA")), then the Agreement is a "netting contract" (as defined in FDICIA) and each payment entitlement and payment obligation is a "covered contractual payment entitlement" or "covered contractual payment obligation," respectively. This provision is intended to assist financial institutions in obtaining netting of their obligations under the Agreement in the context of a bankruptcy or other default.

Annex I: Supplemental Terms and Conditions

The Annexes to the Agreement are formatted in a manner similar to most Annexes to the Association's agreements, namely, they do not contain signature lines and they contain blank spaces at the beginning in which to insert the names of the parties and the date of the agreement. Parties should consider whether they also wish to require separate signatures on each Annex, to help prove, as an evidentiary matter, that a particular party has entered into a particular Annex. Even if not all Annexes are signed, the parties may wish to sign Annex I, which has been drafted to permit the parties to designate the Annexes that will apply to Options under the Agreement.

Annex I is intended to include the identification of any Underlying Securities other than those specified in Paragraph 1(i) and (ii) of the Agreement, and any special provisions relating to Options involving such Underlying Securities, such as provisions for settlement and the like. Annex I may also be used to provide for cash settlement of Options.

Schedule of Optional Provisions for Annex I

The Schedule of Optional Provisions attached hereto contains forms of clauses that parties may elect to use in connection with Annex I of the Agreement. These clauses provide standard language for frequently negotiated supplemental terms.

Submission to Jurisdiction and Waiver of Immunity: The schedule includes a provision under which the parties submit to the non-exclusive jurisdiction of any United States Federal or New York State court and waive any immunity (sovereign or otherwise) with respect to actions brought under the Agreement. This provision is designed to address in particular the possibility that foreign parties using the Agreement might not otherwise be subject to such jurisdiction.

Events of Default: Additional Events of Default have been provided that parties may elect to use. A failure to perform as result of sovereign action or inaction (directly or indirectly) would trigger an Event of Default. In addition, parties that have not entered into a Cross-Product Master Agreement may find it desirable to include a cross-default provision that covers the default by either party with respect to any other indebtedness or agreement between the parties. Parties may in some cases also wish to require non-U.S. signatories to appoint an agent in the United States for purposes of receiving service of process.

In general, parties should also keep in mind the need to specify the circumstances in which the failure to perform any covenant contained in an Annex to the Agreement will constitute an Event of Default.

Financial Statements: Two provisions relate to furnishing financial statements and a representation and warranty with respect thereto.

Marking of Collateral: The parties may wish to include a provision clarifying that the failure to request the transfer of any Option Collateral pursuant to Annex III or IIIa shall not be deemed to have any impact on the determination of the value of any Option Collateral for purposes of later margin calls or in the exercise of remedies.

No Reliance: Finally, the parties may wish to use the "no reliance" representations set forth in the Schedule of Optional Provisions. The absence of these representations in Annex I or otherwise, however, should not be construed to imply the existence of any particular relationship between the parties.

Again, the Association emphasizes that it does not intend by the inclusion of these provisions in the Schedule of Optional Provisions to encourage their use or discourage the use of provisions not included in this Schedule. These provisions are merely meant as examples of provisions frequently negotiated and included in options agreements, but the use of which is not so universal as to warrant inclusion in the body of an Agreement containing only general terms.

Annex II: Addresses for Communication between the Parties

This Annex provides for the parties to list the addresses and contact information to be used for all notices, statements, demands or other communications between the parties, including Notices of Exercise. The parties may wish to provide in Annex I for additional instructions for wire transactions or other deliveries or to expand the permissible means by which a Notice of Exercise can be delivered.

Annex III: Performance Assurance Provisions

The objective of these provisions is to impose margin obligations to secure the parties' aggregate net exposure during the period between the Trade Date and the Settlement Date for all Options. Such obligations are mutual under Annex III and unilateral under Annex IIIa, the Alternative Performance Assurance Provisions described below. Pursuant to Annex III, a party is entitled to call for U.S. Treasury securities or cash as margin having a Market Value at least equal to its "Net Unsecured Option Exposure",

which is defined as the net amount of a party's Option Exposure under all Options. This Annex provides for Option Exposure to be the loss a party would incur upon canceling an Option and entering into a replacement transaction, determined in accordance with market practice. This marks a change from the 1989 version of the Agreement, which utilized the intrinsic value of the Options to determine performance assurance requirements. Parties who prefer to use intrinsic valuation to determine performance assurance requirements may agree that Option Exposure will be determined according to Paragraph 2(e), which defines Option Exposure as the difference between the Market Value of the Underlying Securities and the Exercise Value, plus, as agreed, a percentage of the Market Value of the Underlying Securities. Parties should consider whether the standards for determining Market Value should be set forth in greater detail, particularly if they wish to provide for Collateral other than U.S. Treasury securities or cash.

This Annex incorporates a margin notice deadline (10:00 a.m. on any Business Day) for same-day satisfaction of margin maintenance obligations in connection with Options. If the margin notice deadline is not met, the party receiving such notice must satisfy its margin maintenance obligation by the close of business on the next business day following the business day on which notice is received. "Close of Business," the definition of which is consistent with the one used in the Association's Master Securities Loan Agreement (2000 Version), means the time agreed by the parties or, in the absence of any such agreement, the time determined in accordance with market practice. Parties should consider defining the term "Close of Business" by reference to a particular time zone or location, where appropriate to avoid any ambiguity regarding the time intended.

The parties may agree upon a minimum dollar amount or percentage threshold below which margin calls will not be permitted. The parties may also agree, with respect to any or all Options, to provide for Option-by-Option margin maintenance obligations. Finally, the parties may agree that one party will deposit a minimum dollar amount or percentage with the other party, either on an initial or ongoing basis.

Another provision requires Option Collateral (together with any Income thereon and proceeds thereof) to be transferred by the holder thereof back to the pledgor upon the occurrence of the relevant Settlement Date and the performance by the parties of their respective obligations on such date. The transfer need not be made if such transfer would trigger margin maintenance obligations. Also, the pledgor of Option Collateral may, subject to the agreement of the pledgee, substitute other securities for any pledged securities Option Collateral.

This Annex provides an additional Event of Default for Options: the failure, after one Business Day's notice, to perform any covenant or obligation under this Annex. Through the incorporation of "Option Collateral" into the definition of "Collateral" in Paragraph 4 of the Agreement, the nondefaulting party is entitled, as part of its rights under Paragraph 8 of the Agreement upon an Event of Default, to sell any or all

Option Collateral and apply the proceeds thereof to, or give the defaulting party credit for such Option Collateral against, any amounts owing by the defaulting party.

Annex IIIa: Alternative Performance Assurance Provisions

The mark-to-market provisions of Annex III impose mutual obligations, with both parties agreeing to pledge Option Collateral to the other to address any Net Unsecured Option Exposure of the other party. The Association has also prepared Annex IIIa for use in those situations where the parties decide not to impose mutual obligations. Although almost all the provisions that appear in the bilateral mark-to-market Annex III appear in Annex IIIa as well, the obligations under Annex IIIa are not bilateral, but rather are owed from Party B, the pledgor, to Party A, the pledgee. Thus, only Party B will pledge Option Collateral under this Annex (and only Party A will hold a security interest in any Collateral), to secure all Options, unless otherwise agreed. Again, the parties should consider whether the standards for determining the Market Value should be set forth in greater detail.

"Close of Business," the definition of which is consistent with the one used in the Association's Master Securities Loan Agreement (2000 Version), means the time agreed by the parties or, in the absence of any such agreement, the time determined in accordance with market practice. Parties should consider defining the term "Close of Business" by reference to a particular time zone or location, where appropriate to avoid any ambiguity regarding the time intended.

This Annex also provides for additional Events of Default, namely, (i) the failure by Party B to perform any obligation under any provision of the Annex, (ii) the default by Party B or any affiliate of Party B under any transaction or agreement between Party A or any affiliate of Party A and Party B or any affiliate of Party B and (iii) the default by Party B or any affiliate of Party B with respect to any indebtedness or other agreement creating such indebtedness (parties may wish to add a provision specifying that any such default must be in excess of a minimum amount).

The Annex also provides that an Event of Default under the Agreement constitutes an Event of Default under all other agreements between Party A or any affiliate of Party A and Party B or any affiliate of Party B. The Annex provides that all Collateral secures not only Party B's obligations under the Agreement, but also all obligations of Party B under any other agreement with Party A or any affiliate of Party A. Furthermore, upon an Event of Default, Party A and its affiliates are entitled to exercise default remedies in all transactions with Party B and its affiliates, and may set off obligations in connection with all transactions with Party B (but not with Party B's affiliates), and set off obligations in connection with all transactions with a particular affiliate of Party B (but not with Party B or another affiliate of Party B). Although this Annex provides for a "cross-default" to transactions with Party B's affiliates, it does <u>not</u> provide for setoff between those transactions and transactions with Party B or for a security interest in any assets of Party B's affiliates to secure the obligations of Party B. Parties which use this optional provision should be aware that their counterparties may lack the authority to add additional events of default to their affiliates' contracts.

Party B also agrees in this Annex to give adequate assurances of performance whenever Party A or an affiliate of Party A so demands in writing upon reasonable grounds for insecurity as to the ability of Party B or an affiliate of Party B to perform any obligation it might have under any transaction or agreement with Party A or any affiliate of Party A. Party B must provide adequate assurances of performance within a reasonable time after such demand.

Annex IV: International Transactions

Annex IV contains additional terms and conditions that govern International Transactions. The central objective of Annex IV is to provide guidance with respect to issues presented by payments or parties in different jurisdictions. It is substantially similar to the International Transactions Annex (Annex III) to the Association's Master Repurchase Agreement, which was in turn prepared in conjunction with the 1995 Global Master Repurchase Agreement published jointly by the Association and the International Securities Market Association (the "PSA/ISMA Global Master Repurchase Agreement"). Annex IV also incorporates the provisions of the Annex Relating to European Economic and Monetary Union to the Association's Master Repurchase Agreement; for a detailed discussion of the provisions relating to the European Economic and Monetary Union, parties should consult the Guidance Notes to that Annex.

Definitions

Base Currency. The parties may agree on a currency as the base currency for purposes of calculating amounts payable pursuant to the Agreement or any applicable performance assurance annex. In the absence of any such agreement between the parties, the U.S. dollar is designated as the base currency.

Business Day and Exercise Hours. These definitions modify the definitions included in Paragraph 2 of the Agreement to apply more precisely in relation to exercise, expiration and settlement in different jurisdictions. For the purpose of exercise and expiration of an Option, Business Days and Exercise Hours are defined with reference to the principal market for purchases and sales of the Underlying Securities for an Option. For the purpose of settlement, Business Days are defined with reference to the means of settlement or the principal financial center of the currency being used. As revised, the Agreement no longer provides that a notice received on a date on which the recipient is closed for business shall be deemed received on the next day on which such party is open for business. Parties should note that because the provisions relating to exercise and expiration of an Option are generally defined with respect to the principal market of the Underlying Securities, either or both of the Writer and the Holder could be closed for business on an exercise or Expiration Date. The parties should consider adopting appropriate definitions of "Business Day," "Close of Trading," "Exercise Hours" and "Expiration Date" (in Schedule IV.A) where ambiguities may otherwise arise – e.g., because parties are located in different time zones or jurisdictions – as to the days and times at which deadlines occur under the Agreement and Annex IV.

International Security. An International Security is defined broadly to include any Underlying Security denominated in a currency other than U.S. dollars, capable of being cleared through a clearing facility outside the United States or issued by an issuer organized under the laws of a jurisdiction other than the United States (or any political subdivision thereof). The intent of this definition is to provide parties with the flexibility to use Annex IV for a wide range of transactions if they so desire.

International Transaction. An International Transaction is defined to include any Option involving an International Security, a party organized under the laws of a jurisdiction other than the United States (or any political subdivision thereof) or having its principal place of business outside the United States or a branch or office outside the United States designated in Annex I by a party organized under the laws of the United States (or any political subdivision thereof) as an office through which that party may act when entering into Options governed by the Agreement.

Manner of Transfer
Paragraph 2 of Annex IV sets forth the requirements for transfers of International Securities, which may be made by transfer through Euroclear or CEDEL, any other agreed securities clearing system or such other means as the parties may agree.

Contractual Currency
Paragraph 3 of Annex IV requires all payments to be made in the Contractual Currency (defined as the currency in which the relevant International Securities are denominated unless otherwise agreed). The party entitled to receive a payment may, at its option, accept payment in a currency other than the Contractual Currency, in which case this Paragraph seeks to minimize the exchange risks to which the party receiving payment is subject. Payments made in any currency other than the Contractual Currency discharge the payor's payment obligation only to the extent the recipient is able to purchase the Contractual Currency with the amount tendered in the other currency. Except where an Event of Default with respect to the payee has occurred, the party making payment remains liable for any shortfalls in amounts due in the Contractual Currency, including shortfalls after any judgments or orders against that party in another currency have been converted to the Contractual Currency. If the amount in the Contractual Currency received upon conversion of the tendered currency exceeds the amount due, the recipient, except where an Event of Default with respect to the payor has occurred, must refund the difference. The enforceability of these provisions will be subject to applicable law and judicial practice.

Paragraph 3(e) provides that the $1 million aggregate face amount of securities used in the automatic exercise provision of the Agreement shall be the equivalent in the Contractual Currency.

Taxes
Because payments made by one party to a party in another country may be subject to withholding tax, Paragraph 5 of Annex IV provides, consistent with similar provisions

in other types of agreements involving cross-border payments under financial instruments, that if a party obligated to make a payment (the "Payor") is required to withhold tax on that payment, the Payor must "gross up" the payment so that the other party (the "Payee") will be made whole. For this purpose, a tax imposed by reason of a connection between the Payee and the taxing jurisdiction generally is excluded from the definition of a "Tax" for which a gross-up payment is required to be made. Similarly, any change in such a tax will not trigger the change of tax law provision of Paragraph 6.

In those cases where the delivery of a certificate or other document by the Payee would reduce or eliminate the rate of withholding tax, the Payee is required to deliver that document or certificate upon reasonable request by the Payor and to notify the Payor if the certificate or document ceases to be true for reasons other than a change in tax law. The Payor is not required to gross up to the extent that the Payee fails to comply with those requirements. Paragraph 5 thus places the risk of withholding tax upon the Payor in the first instance, but shifts that risk to the Payee to the extent that the imposition of withholding tax results from a failure by the Payee to take reasonable steps to reduce or eliminate the tax, including advising the Payor of facts likely to be within the sole knowledge of the Payee. It is anticipated that the parties will agree to alternative arrangements should they so desire. Parties may consider adding provisions for the transfer of Options Contracts in circumstances requiring a party to "gross up" a payment.

The tax provisions of this Annex are concerned with transfer and other taxes on payments of option premium and payments and transfers of Underlying Securities upon the exercise of Options Contracts. They are not intended to deal with any taxes (including withholding taxes) which might be imposed on the pledge, rehypothecation or assignment of Option Collateral or on the income on Option Collateral. Parties to an Agreement which includes a non-U.S. party and either Annex III or Annex IIIa should consult their tax advisors regarding appropriate provisions relating to Option Collateral. (Parties using Annex III or IIIa may also wish to provide for the conversion of sums not denominated in the Base Currency into the Base Currency in calculations of Net Unsecured Option Exposure.)

Tax Event

Paragraph 6 of Annex IV allows a party to terminate an International Transaction, upon notice to the other party, in the event that any action relating to withholding tax taken by a revenue authority or brought in a court of competent jurisdiction or any change in tax law or practice has a material adverse effect on that party in the context of the International Transaction. This provision is based upon the comparable provision of the PSA/ISMA Global Master Repurchase Agreement, but provides that the tax must be one required to be collected by withholding or deduction (e.g., a gross income tax) and that the action or change of law must take place after the date the International Transaction is entered into.

In order to ensure that an International Transaction is not terminated unless there is a substantial likelihood that the change of tax law will have a material adverse effect on the notifying party, the other party may require the notifying party to provide an opinion of counsel that a change of tax law has taken place and affects the notifying party. The parties may wish to consider adding a provision requiring the affected party to use reasonable efforts to transfer any affected International Transaction to another branch or office if the International Transaction would no longer be affected by the change of tax law after the transfer, as is provided in the Master Agreement published by the International Swaps and Derivatives Association, Inc. Such a provision was not included in Paragraph 6 because OTC options generally are of a shorter term than transactions documented under an ISDA Master Agreement and because market participants have different views as to the desirability of such a transfer provision.

In some cases, a party may prefer to bear the cost of a change of tax law rather than terminate an International Transaction. If that party is the party affected by the change of tax law, such party may elect not to provide the notice referred to above, in which case the provisions of Paragraph 6 will not be invoked. If that party is the other party, such other party may override the notifying party's election to terminate the International Transaction, but in so doing such other party will agree to indemnify the notifying party against the relevant adverse effect. The relevant adverse effect may include, for example, a gross up obligation on payments made by the notifying party to the other party under Paragraph 5 of Annex IV.

Events of Default

Paragraph 7 of Annex IV provides an additional Event of Default for International Transactions: the failure, after one business day's notice, to perform any covenant or obligation required under Annex IV. The nondefaulting party is also entitled, in addition to its rights under Paragraph 8 of the Agreement, to convert any currency into a different currency and offset obligations of the defaulting party denominated in different currencies against each other.

Annex V: Party Acting as Agent

Annex V adapts the terms of the Agreement to govern agency Options and addresses a number of practical and legal issues in this context. The central objective of Annex V is to assist parties entering into Options in determining who, as between the agent and its principal(s), is liable for performance under the Agreement. It has been modeled after an annex to the Association's Master Securities Forward Transaction Agreement, which, in turn, was modeled on similar annexes to the Association's Master Repurchase Agreement and Master Securities Loan Agreement.

Paragraphs 1 and 2 require the party acting as agent to disclose the identity of the principal(s) for whom it intends to act as agent and to represent and warrant that each such principal has authorized it to execute and deliver the Agreement, to enter into the Options and to perform the obligations of the principal(s) thereunder. As used in Paragraph 2, "Close of Business," the definition of which is consistent with the one used in the Association's Master Securities Loan Agreement (2000 Version), means

the time agreed by the parties or, in the absence of any such agreement, the time determined in accordance with market practice. Parties should consider defining the term "Close of Business" by reference to a particular time zone or location, where appropriate to avoid any ambiguity regarding the time intended.

Paragraph 3 sets forth general rules limiting the agent's liability under the Agreement. Where the agent has, through compliance with the provisions of the Agreement, taken the steps necessary to permit the other party to the Agreement to assess the creditworthiness of its principal(s), the agent's obligations do not include a guarantee of performance by its principal(s) and the other party's remedies do not include a right of setoff with respect to any obligations between the agent, acting for its own account, and the other party.

Paragraph 4 provides that when an agent acts on behalf of multiple principals, the Agreement presumes that the Options will be treated as multiple Options on behalf of separate principals, unless the parties agree in writing to treat the Options as if they were Options by a single principal. This Paragraph also sets forth the rights and obligations of the agent with respect to each situation.

Paragraph 5 sets forth a general rule of construction for the terms "party," "parties," "Writer" and "Holder," as the case may be, in the Agreement in the context of agency Options, subject to the limitation of an agent's liability in Paragraph 3 of Annex V. This Paragraph explicitly acknowledges that each principal has the rights, responsibilities, privileges and obligations of a "party" that enters directly into Options with another party, and that the agent has been designated as the sole agent of each principal for performance of such party's obligations to the other party, and for receipt of performance by the other party in connection with the Options. The terms "party" and "either party" are deemed to refer to both the agent and the principal(s), including, *inter alia*, in the context of a default.

Schedule of Optional Provisions

[ ]. Additional Securities Covered by the Agreement.

[ ]. Submission to Jurisdiction and Waiver of Immunity.

(a) Each party hereto irrevocably and unconditionally (i) submits to the non-exclusive jurisdiction of any United States Federal or New York State court sitting in Manhattan, and any appellate court from any such court, solely for the purpose of any suit, action or proceeding brought to enforce its obligations under the Agreement or relating in any way to the Agreement or any Option and (ii) waives, to the fullest extent it may effectively do so, any defense of an inconvenient forum to the maintenance of such action or proceeding in any such court and any right of jurisdiction on account of its place of residence or domicile.

(b) To the extent that either party hereto has or hereafter may acquire any immunity (sovereign or otherwise) from any legal action, suit or proceeding, from jurisdiction of any court or from setoff or any legal process (whether service or notice, attachment prior to judgment, attachment in aid of execution of judgment, execution of judgment or otherwise) with respect to itself or any of its property, such party hereby irrevocably waives and agrees not to plead or claim such immunity in respect of any action brought to enforce its obligations under the Agreement or relating in any way to the Agreement or any Option.

[ ]. Additional Events of Default. In addition to the Events of Default set forth in Paragraph 8 of the Agreement, it shall be an "Event of Default" if:

(a) as a result of sovereign action or inaction (directly or indirectly), a party becomes unable to perform any absolute or contingent obligation to make a payment or transfer or to receive a payment or transfer in respect of any Option or to comply with any other material provision of the Agreement relating to such Option; or

(b) either party defaults with respect to any other agreement between the parties.

[ ]. Representations and Warranties. In addition to the representations and warranties made pursuant to Paragraph 7 of the Agreement, each party in addition represents and warrants to the other party that no material adverse change in such party's financial condition has occurred since the date of the most recent financial statements furnished by such party to the other party, and such financial statements are complete and correct and fairly present such party's financial condition and results of operations as at and for the period ended on the date thereof, all in accordance with generally accepted accounting principles and practices applied on a consistent basis.

[ ]. Provision of Financial Statements. Each party agrees to furnish to the other party promptly after the end of each [semi-annual period] [fiscal quarter] copies of its balance sheet and its income statement for the interim period then ended, certified, subject to changes resulting from normal, recurring year-end audit adjustments, by a principal financial officer, and to furnish the other party as soon as available after the end of each fiscal year copies of its balance sheet

and income statements as of the end of such year and of its changes in financial position for the said fiscal year as certified by its independent public accountants.

[ ]. Marking of Collateral. In no event shall the failure of either party to request the transfer of any Option Collateral pursuant to any Annex to the Agreement be deemed to have any impact of the determination of the value of any Option Collateral, whether for purposes of such Annex or in the exercise of remedies pursuant to Paragraph 8 of the Agreement.

[ ]. No Reliance. In addition to the representations and warranties set forth in Paragraph 7 of the Agreement, each party hereby makes the following representations and warranties in connection with the Agreement and each Option thereunder, which shall continue until the settlement of any such Option:

(a) unless there is a written agreement with the other party to the contrary, it is not relying on any advice (whether written or oral) of the other party, other than the representations expressly set out in the Agreement;

(b) it has made and will make its own decisions regarding the entering into and exercise of any Option based upon its own judgment and upon advice from such professional advisers as it has deemed it necessary to consult; and

(c) it understands the terms, conditions and risks of each Option and is willing to assume (financially and otherwise) those risks.