

Global Documentation Steering Committee

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Thomas A. Russo's Presentation to the G30 Monitoring Committee Re: Recommendations 14-16

Recommendation 14: Strengthen Assessment of the Enforceability of Contracts

Validity and Enforceability of Contracts

- Most firms have guidelines and procedures for entering into and effecting contracts, including procedures for obtaining legal opinions or other advice and for reviewing evidence of authority and capacity. Firms also have contractual provisions for various types of counterparties, jurisdictions and products
- Many market sectors make use of industry association sponsored forms of agreement, such as those published by ISDAⁱ and TBMAⁱⁱ. These forms have undergone extensive review which, while never a substitute for a firm's own review, helps guard against fundamental contractual inadequacies. The GDSCⁱⁱⁱ, furthermore, has undertaken a number of initiatives to promote harmonization of contractual provisions among master agreements. These initiatives will further facilitate higher documentation standards and help avoid the practical enforcement issues that may arise when a deteriorating relationship is subject to multiple, potentially inconsistent agreements
- ISDA and other groups and trade associations, such as the FMLG^{iv} and ISMA,^v have obtained a number of legal opinions with respect to closeout netting and collateral. These opinions, along with other advice, are currently used by industry participants as part of their due diligence procedures. For example, ISDA's 43 netting and 33 collateral opinions are available through the online/web-based services CSAnalytics and Netalytics
- The GDSC has been working to increase efficiency in contract execution. The GDSC recently published best practices in negotiating master agreements and hosted a conference on those best practices
- Firms need to ensure that they have procedures in place that address contract execution and enforceability. In addition, going forward, trade associations and other industry participants should work together to formulate best practices in this area

Recommendation 15: Advance Legal Certainty Over Rights to Securities, Cash, or Collateral

- Market participants must be able to determine, with certainty and reasonable cost and effort, what law governs their rights to securities, cash or collateral in a clearing and settlement system, what those rights are and how to perfect and enforce them. This breaks down into two main areas: conflicts of laws and substantive legal issues

Conflict of Laws

- The G30 and the European Commission have called for the adoption of the *Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held*, which aims to provide legal certainty and predictability as to the law governing issues that are of crucial practical importance for holdings and dispositions of securities held with an intermediary. EU member states endorsed the European Commission's proposal to sign the Convention
- The Hague Convention was scheduled to be signed on December 17, 2004. However, there has been some recent concern that the Convention represents a US bias
- In reality, the Hague Convention was the result of an inclusive process, where

financial market participants joined with regulators and academics to draft a clear conflicts of law rule relating to securities transfers. The Drafting Committee for the Convention included fifteen experts – twelve from Europe, one from Japan, one from Canada and only one from the US. Ten were from civil law countries

- The Hague Convention is purely a conflicts of law convention. Its adoption is crucial because it will permit a party taking an interest in securities held with an intermediary to determine, ahead of time, what law will govern the pledging, priority and perfection of the securities. Therefore, in the event of a counterparty insolvency, the account holder will have been able to ensure that it has a valid, perfected security interest in the securities and will be able to effectively enforce its rights
- In this global world, *ex ante* certainty with respect to governing law simply improves the efficiency of the markets. This is parallel in many ways to the efforts of the GDSC to encourage harmonization in standard documentation used in the over-the-counter markets so that when firms transact in different over-the-counter markets through different agreements, disparities in documentation (i.e., “documentation basis risk”) do not exacerbate market, credit or legal risk
- It is imperative that the signing of the Hague Convention not be unduly delayed. This is a significant opportunity for member states of the Hague Convention to clarify laws applicable to securities transfers and thereby increase the size and liquidity of their capital markets

Substantive Legal Issues

- Two years ago, UNIDROIT^{vi} launched a securities project to harmonize the substantive rules governing securities held with an intermediary
- This ambitious project aims to standardize the substantive legal framework governing cross border clearing and settlement. It does not address conflicts of laws, which are covered by the Hague Convention. For example, it would define a party’s rights against an intermediary and its creditors in the event the intermediary became insolvent
- This project is in its early stages, and a draft convention is currently under consideration

Recommendation 16: Recognize and Support Improved Valuation Methodologies and Closeout Netting Arrangements

- Most master agreements provide for closeout netting in an insolvency and include a valuation process for closing out transactions. For example, the Close-out Amount definition in the 2002 ISDA Master Agreement was the product of industry-wide negotiations and represents a broad market compromise on a commercially reasonable procedure for closeout valuation methodology
- Netting laws vary from country to country. Some countries, such as the US and France, have favorable netting laws, whereas others, particularly in the Middle East and parts of Asia and South America, are at the other extreme. Even in jurisdictions such as the US, certain market participants (e.g., insurance companies or pension plans) are not clearly covered by the federal bankruptcy laws and their safe harbors for closing out financial contracts
- Failure to address the legislative scheme creates legal uncertainty even where parties have successfully executed a contract because the bankruptcy laws of a party’s jurisdiction will typically override the governing law chosen by the parties. The EU Insolvency Regulation and related Directives are helpful in this regard in applying the contractual governing law to netting issues. The ISDA Model Netting Act provides a roadmap to jurisdictions seeking to modernize their insolvency laws to achieve closeout netting
- Going forward, market participants must continue to standardize market practices, including documentation, legislative mandates and regulations.

- With respect to documentation, this has been a major focus of the GDSC, which advocates that documents should be conformed in terms of grace periods in events of default, force majeure provisions, and other termination triggers, as well as valuation methodology
- The above initiatives require the collaboration and support of major market participants, governments and central banks

ⁱ The International Swaps and Derivatives Association (“ISDA”) is the global trade association representing participants in the privately negotiated derivatives industry, a business covering swaps and options across all asset classes (interest rate, currency, commodity and energy, credit and equity). ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business

ⁱⁱ The Bond Market Association (“TBMA”) is the trade association representing the estimated \$44 trillion global debt securities markets. TBMA fosters improvement in the legislative, regulatory, educational and market practice arenas for all participants in the bond markets

ⁱⁱⁱ The Global Documentation Steering Committee (“GDSC”) is a group of major, internationally active commercial and investment banks and other institutions that deal in and use financial products available in the over-the-counter markets. The GDSC’s mission has been to help create standardized documentation to assist participants in the over-the-counter markets in avoiding the risks, particularly in market crises, that inconsistent documentation may foster

^{iv} The Financial Markets Lawyers Group (“FMLG”) is an independent body which meets under the sponsorship of the Federal Reserve Bank of New York. It is composed of attorneys who possess a broad knowledge of the financial markets, especially foreign exchange, and who work for institutions actively involved in foreign exchange and other financial markets

^v The International Securities Market Association (“ISMA”) is the self-regulatory organization and trade association for the international securities market. Since its origins, ISMA has performed a central and crucial role by providing a global framework of industry-driven rules and recommendations which regulate and guide trading and settlement in this market

^{vi} The International Institute for the Unification of Private Law (“UNIDROIT”) is an independent intergovernmental organization with its seat in the Villa Aldobrandini in Rome. Its purpose is to study needs and methods for modernizing, harmonizing and coordinating private and in particular commercial law between States and groups of States. Membership of UNIDROIT is restricted to States acceding to the UNIDROIT Statute. UNIDROIT’s member States are drawn from the five continents and represent a variety of legal, economic and political systems as well as different cultural backgrounds