

User's Guide: Revised Force Majeure Provisions

This User's Guide is released by The Foreign Exchange Committee (the "FX Committee") to accompany revisions published by the FX Committee on this date (the "New Provisions") to the Force Majeure, Act of State, Illegality and Impossibility Section ("Force Majeure Provision") in each of the International Foreign Exchange Master Agreement ("IFEMA"), International Foreign Exchange and Options Master Agreement ("FEOMA") and International Currency Options Market Master Agreement ("ICOM" and, collectively with IFEMA and FEOMA, the "Agreements"), previously issued by the FX Committee in association with The British Bankers' Association, The Canadian Foreign Exchange Committee and The Tokyo Foreign Exchange Market Practices Committee. This User's Guide will provide background and other information to assist foreign exchange market participants in implementing the New Provisions. The New Provisions and this User's Guide are not intended to interpret or define the scope of the Agreements as now in effect. (Capitalized terms used in this User's Guide are as defined in the New Provisions or the Agreements, unless otherwise specified.)

Background

In May, 1998, in the wake of crises in various international financial and currency markets, the FX Committee's Financial Markets Lawyers Group formed a Subcommittee (the "Subcommittee") to consider these events. In particular, the Subcommittee was charged to consider whether, in the event of major market dislocations, the Force Majeure Provisions of the Agreements and other existing industry standard documentation would lead to a market-responsive result that was appropriate from a risk management perspective. The Subcommittee received extensive comment from, and held meetings with, representatives of a large group of commercial and investment banks. In addition, non-voting representatives of ISDA, EMTA and the Federal Reserve Bank of New York participated in this process.

Preliminary Conclusions

The first conclusion of the Subcommittee was that, in the event of the occurrence of an impossibility, illegality or other force majeure event, the results under the Agreements, as well as under other standard industry documentation such as the ISDA Master Agreement and relevant ISDA Definitions, were not always consistent and did not appear to reflect current market practices or market needs. There also appeared to be some disagreement on how to interpret certain key terms of these documents. The Subcommittee was concerned that these inconsistencies could result in market participants taking contradictory positions in times of market difficulty, leading to a reduced level of legal certainty and confusion in the market. Although the Subcommittee members were aware that, in the wake of last year's disruptions, quick, decisive and generally consistent action by market participants had prevented potentially destabilizing market reactions, the Subcommittee as a whole was concerned that the result could be different in the future.

The Subcommittee determined that the best way to achieve the goals the FX Committee had set for it would be to draft revised provisions which would address current market practice and needs. After consultation with the FX Committee, the Subcommittee prepared the New Provisions. The FX Committee believes the New Provisions will provide guidance to the foreign exchange market as to current "best practices" as well as respond to a perceived need to revise the Force Majeure Provisions of the FX Committee's Agreements.

Use of the New Provisions

The Subcommittee recognizes that each market participant retains the freedom to include or exclude particular provisions from some or all of its Agreements and to negotiate whatever terms it deems appropriate with each of its counterparts. Accordingly, the New Provisions will apply only to the extent that market participants choose to include them in new Agreements or to amend existing Agreements to replace current Force Majeure Provisions with the New Provisions. Nonetheless, the FX Committee believes that the New Provisions both reflect and will promote best practice in the market and, as a consequence, expects that the New Provisions will be used by many market participants.

The New Provisions are designed to be amendments to the Agreements and, as such, are generally intended to apply to deliverable FX Transactions and Options ("Transactions"). Parties can, of course, elect to apply the New Provisions to non-deliverable Transactions. In addition, if the Parties to an Agreement are entering into non-deliverable Transactions under that Agreement, or using a comparable provision in an ISDA Schedule, then any non-deliverable Transaction governed by that Agreement or ISDA Master Agreement would be covered by the New Provisions. If the Parties would prefer that specific disruption events (such as those contained in the 1998 ISDA, EMTA and FX Committee FX and Currency Option Definitions (the "1998 FX Definitions")) apply to their non-deliverable Transactions, they should so provide in the applicable documentation.

The Subcommittee also notes that there will undoubtedly be Transactions under which, to meet the specific needs of the Parties, the Parties choose to allocate risk, and elect specific disruption fallbacks which provide for outcomes, different than those set forth in the New Provisions. Even if Parties to one or more of the Agreements have adopted the New Provisions, they can still elect to apply specific disruption events and disruption fallbacks to one or more Transactions. The Subcommittee refers market participants to the 1998 FX Definitions, which contain many helpful definitions and other provisions in this regard.

In order to enable Parties to give effect to the New Provisions under outstanding documentation, the FX Committee also has released a "Form of Amendment To Incorporate The New Force Majeure Provisions Into The IFEMA/ICOM/FEOMA Agreements." This form may be executed as an amendment or Addendum to the appropriate Agreement. It also may be adapted for use with ISDA or other master agreements, such as versions of the IFEMA and ICOM Agreements published prior to 1997. The form makes clear that the New Provisions govern all Transactions, unless (as discussed in the preceding paragraph) the parties agree upon specific disruption events or disruption fallbacks for one or more Transactions.

In March, 1998, in connection with the publication of the 1998 FX Definitions, the FX Committee published the 1998 FX and Currency Option Definitions Addenda for the IFEMA, The Foreign Exchange Committee
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ICOM and FEOMA Agreements. If the Parties to an Agreement have executed such an Addendum, it is effective as a "Bridge Agreement" for the 1998 FX Definitions. If these Parties also adopt the New Provisions, they agree to reverse a presumption in the "Bridge Agreement" that, unless otherwise specified in the Confirmation, certain disruption events and disruption fallbacks automatically apply to all Transactions executed by the Parties under the relevant IFEMA, ICOM or FEOMA Agreement. (See the Guide to the 1998 FX Definitions Addenda for further information.) The New Provisions are intended to supersede this provision of the "Bridge Agreement" by requiring the Parties to expressly agree (in a manner contemplated by the relevant Agreement) if they wish to apply specific disruption events or disruption fallbacks to one or more of their Transactions in lieu of the New Provisions.

Explanation of the New Provisions

The New Provisions include a proposed new Section 6 for the IFEMA Agreement and a proposed new Section 9 for the FEOMA and ICOM Agreements, which would replace these Sections of the Agreements as published in 1997 (the "1997 Provisions"). The Subcommittee understands that an ISDA Committee is reviewing the same issues at this time.

The principal changes from the 1997 Provisions are as follows:

Definition of Force Majeure Event

To provide a more definitive statement of the types of events which trigger the rights under the New Provisions, they define the term Force Majeure Event. In addition to being more precise than the 1997 Provisions on point, the principal substantive changes from the 1997 Provisions are:

1. Events Covered. The New Provisions, like the 1997 Provisions, cover any force majeure, act of state, illegality or impossibility event that has the specified effect based on the particular facts and circumstances of that event. The New Provisions clarify that, for an event to be a Force Majeure Event, it must be beyond the reasonable control of the Affected Party to overcome.

2. Events that Will Affect Transactions in the Future. Under the 1997 Provisions, a triggering event is deemed to occur in advance of the day on which a Transaction is to settle if a Party has a good faith belief that a force majeure or other relevant event will occur. The Subcommittee was of the view that one Party's good faith belief about a future event was not a high enough standard to permit early termination of Transactions. However, the Subcommittee was also of the view that, once a Force Majeure Event affecting a Currency had occurred, all Transactions in that Currency should be subject to early liquidation, even if the date on which the Transactions were to settle was months or years in the future. This concept is now incorporated into the definition of the term Force Majeure Event.

3. Termination of Less Than All Transactions. Of course, even if a Party has the right to liquidate all Affected Transactions, a Party may elect not to do so. This is particularly true when the Force Majeure Event is one generally referred to as an Act of God (such as a fire, earthquake, flood or other natural event) the effect of which reasonably can be expected to pass within a period of time. However, there may be other Force Majeure Events in respect of which a Party

determines not to liquidate all Affected Transactions immediately after the Waiting Period. In order to grant the Parties reasonable flexibility should they determine not to liquidate all Transactions, the New Provisions clarify that any Party that elects to liquidate only some Transactions can liquidate additional Transactions on any later day or days if the relevant Force Majeure Event is still in effect.

Waiting Period:

In the 1997 Provisions, before a Party can exercise its right to terminate and liquidate Transactions affected by a relevant event, it may be required during a 20 day waiting period to attempt to transfer its obligations to another office through which it can perform (*i.e.*, transfer or receive the affected Currency). The ISDA Master Agreement has a similar provision for Illegality, but the waiting period extends to 30 days. In either case, the FX Committee recognizes that the concept of an extended waiting period is inconsistent with the operation of today's global foreign exchange marketplace. As a result, the New Provisions remove this concept from the Agreements.

In its place, the New Provisions include a standard "Waiting Period" of three Business Days before Affected Transactions can be terminated as a result of a Force Majeure Event. During the Waiting Period, the Parties would be unable to take any action to terminate or liquidate Affected Transactions solely by reason of the occurrence of a Force Majeure Event. The FX Committee believes that, in many cases, waiting three Business Days will allow the precipitating event to pass, thereby avoiding what might be an unnecessary disruptive liquidation of a market. Many participants in the process of drafting the New Provisions pointed to experience in Indonesia as an example where immediate termination and liquidation of Transactions would have proven to be premature and unnecessary. However, if the Force Majeure Event does not pass by the end of the Waiting Period, the Waiting Period will allow the marketplace to prepare for an orderly termination and liquidation of Affected Transactions.

Business Day:

The Subcommittee wanted to avoid any confusion as to whether a Force Majeure Event can cause a day not to be a Business Day (and thereby extend the Waiting Period). The New Provisions clarify that a Business Day includes any day that, but for the Force Majeure Event, would have been a Business Day. Accordingly, the occurrence of a Force Majeure Event triggers, but does not affect the length of, the Waiting Period of three Business Days. (For example, December 31 would ordinarily be a Business Day, since banks are generally open on that date unless it falls on a weekend; however, for 1999, it would not be a Business Day in any jurisdiction that announced significantly in advance of that date that it would be a banking holiday.)

Early Termination:

If a Force Majeure Event continues after the expiration of the Waiting Period, then the New Provisions, in a manner similar to the 1997 Provisions, grant each Party the right (but not the obligation) to elect to liquidate any or all outstanding Transactions involving the affected Currency and settle mark-to-market differences in U.S. dollars (or another unaffected Currency), regardless of when the settlement date is scheduled to occur. As explained above, termination would apply to Transactions involving the affected Currency even when the settlement date for such Transactions is several months or even years in the future.

The New Provisions include one substantive change in this regard. Under the 1997 Provisions, if both Parties were affected by the relevant event, then the Party that gave notice of the event made the necessary calculations. On consideration, the Subcommittee did not view who gave notice as relevant to which Party should calculate. In addition, this provision could result in a Party's rushing to give notice at the first sign of a possible Force Majeure Event in order to control the calculation, rather than wait until the situation becomes clearer and, perhaps, resolves itself. The New Provisions, by contrast, provide that, if both Parties are affected by the event, then both Parties do the calculations in good faith, and the relevant amounts are the average of the calculations of the two Parties. However, to avoid the situation where one Party elects to liquidate but the other refuses to provide the necessary calculations, and even though this would clearly be a breach of the good faith requirement, the New Provisions expressly state that, if a Party fails to so determine an amount, the amount determined by the other Party shall govern.

If there is only one Affected Party, the New Provisions and the 1997 Provisions both provide that the non-Affected Party performs the calculations. Although the New Provisions permit liquidation of less than all Affected Transactions, the fact that only the non-Affected Party performs the calculations when there is only one Affected Party should not present any concerns of "cherry picking" – that the non-Affected Party would liquidate those Affected Transactions favorable to it but not those which are unfavorable to it – since either Party can elect which Affected Transactions are to be liquidated. Accordingly, if the non-Affected Party elects to liquidate only some Affected Transactions, the Affected Party (even though it cannot perform the calculations) could determine that additional Affected Transactions are to be liquidated. It should also be noted that cherry-picking itself is generally a significant issue in the event of a Party's insolvency, as the insolvent Party could attempt to force performance of Transactions favorable to it while rejecting or defaulting under Transactions unfavorable to it with damages to be paid at a fraction of full value. By contrast, when both Parties are solvent, all obligations will eventually be satisfied (although in the interim significant mark-to-market issues could arise).

The New Provisions also clarify that it is the occurrence of a Force Majeure Event, not notice of that Event, that triggers the Waiting Period and any subsequent early termination of Affected Transactions.

It should be understood that any two Parties are able at any time, including during the Waiting Period, to agree to take an alternate action. It should also be understood that a Party could still, of course, terminate and liquidate any Transactions to the extent its counterpart's failure to perform was not caused solely by a Force Majeure Event (such as a bankruptcy or insolvency of a counterpart or its Credit Support Provider, or failure to provide adequate assurance or otherwise perform, even if caused, in part, by the Force Majeure Event).

Event That is Both a Force Majeure Event and an Event of Default:

The Subcommittee wanted to avoid any confusion on the effect of an event that is both a Force Majeure Event and an Event of Default. The New Provisions clarify that such an event is treated as a Force Majeure Event, not as an Event of Default. Of course, if an event occurs that is a Force Majeure Event, and at the same time another event (other than the mere failure to make payment as a result of that Force Majeure Event) occurs that constitutes an Event of Default under an Agreement (for example, if a Party becomes bankrupt or insolvent, and even if that

bankruptcy or insolvency is caused by the Force Majeure Event), that other event would be an Event of Default under that Agreement.

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The FX Committee is presenting the New Provisions to the foreign exchange market with the expectation that they reflect and will help strengthen best practice in such market and facilitate the maintenance of an orderly market during times of crisis.