User's Guide to the 2001 ISDA Margin Provisions

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THIS USER'S GUIDE DOES NOT PURPORT TO BE, AND SHOULD NOT BE CONSIDERED TO BE, A GUIDE TO OR EXPLANATION OF ALL ISSUES AND OTHER CONSIDERATIONS THAT MAY BE RELEVANT TO A PARTICULAR MARGIN ARRANGEMENT, INCLUDING RELEVANT ENFORCEABILITY, REGULATORY, TAX, ACCOUNTING AND OTHER CONSIDERATIONS. EACH PARTY SHOULD CONSULT WITH ITS LEGAL AND TAX ADVISERS AND ANY OTHER ADVISERS IT DEEMS APPROPRIATE PRIOR TO USING ANY ISDA STANDARD PROVISIONS. ISDA ASSUMES NO RESPONSIBILITY FOR ANY USE TO WHICH ANY OF ITS PROVISIONS OR ANY DEFINITION OR PROVISION CONTAINED IN ITS PROVISIONS MAY BE PUT.

USER'S GUIDE TO THE 2001 ISDA MARGIN PROVISIONS

I. GENERAL

A. Overview

The 2001 ISDA Margin Provisions (the "Provisions"), published by the International Swaps and Derivatives Association, Inc. ("ISDA"), set out standard terms for a margin arrangement between two parties to an agreement relating to financial transactions.

While intended by ISDA primarily for use with an ISDA Master Agreement,[1] the Provisions were deliberately drafted to make it possible to use them with other forms of agreement not published by ISDA. References below to an "Agreement", unless context indicates otherwise, are to any master agreement, including the ISDA Master Agreement, to which a Supplement incorporating the Provisions relates. References to "Close-out Date" are, in relation to an ISDA Master Agreement, to an Early Termination Date and, in relation to a non-ISDA Agreement, to a date on which all Obligations under that Agreement have been accelerated, terminated, liquidated or cancelled as a result of an Event of Default or Specified Condition. Users should consult their legal advisers in relation to the suitability of the Supplement for use with an Agreement other than the ISDA Master Agreement.

Note that the Provisions also allow for the possibility of collateralising the aggregate net exposure of a party under more than one Agreement. This possibility is discussed at various places in this Guide, but particularly, in Part II.D.1 and Part IV below.

A capitalised term used without definition in this Guide is intended to have the meaning given to that term in the Provisions or the ISDA Master Agreement, depending upon the context in which it is used.

Parties may create a margin arrangement using the Provisions by entering into a 2001 ISDA Margin Supplement (the "Supplement") incorporating these Provisions. A form of Supplement is set out in Appendix A to the Provisions.

The Supplement forms part of, and is governed by, the Agreement to which it relates. Because it incorporates the Provisions, it is a relatively short form. To complete the Supplement, the parties need to make various elections and to specify other information. The Provisions describe the elections to be made and the information to be specified. The parties may also modify or add to the Provisions in the Supplement. Specific guidance on completing the Supplement is given in Part IV below.

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1 The Provisions may be used with either of the two forms of master agreement published by ISDA in 1992, the ISDA Master Agreement (Multicurrency - Cross Border) and the ISDA Master Agreement (Local Currency - Single Jurisdiction). The Provisions may also be used with the two forms of master agreement published in 1987, the ISDA Interest Rate and Currency Exchange Agreement and the ISDA Interest Rate Swap Agreement. However, in the case of the 1987 forms, some additional drafting will probably be necessary, especially if the parties wish to elect the title transfer approach under English law (as discussed below in this Guide).

The Provisions, incorporated into the Supplement, provide both operational provisions, determining the mark-to-market margin delivery obligations, and legal provisions. The legal provisions establish the legal nature of transfers under the margin arrangement. The parties may choose:

- a security interest (pledge) approach, governed by New York law; or

- a title transfer approach, governed by English law.

The parties elect in the Supplement which of these will apply to their margin arrangement. In addition, if Japanese Margin may be delivered, the parties may elect to have specific provisions governed by Japanese law apply to the transfer of Japanese Margin. The Provisions, as currently drafted, assume that this choice is made only after the basic legal approach has been chosen.[2]

Note on terminology

The arrangements contemplated by the Provisions are commonly referred to in the market as "collateral" or "margin" arrangements. Neither of these terms has traditionally been regarded as a legal term, although recently both, and in particular "collateral", have begun to appear in statutes and regulations relating to financial matters.

In previously published ISDA documents, these types of arrangements were referred to as "credit support" arrangements, largely for consistency with the terms "Credit Support Document", "Credit Support Provider" and "Credit Support Default", which appear in the 1992 versions of the ISDA Master Agreement. In those versions, the concept of "credit support" includes guarantees, letters of credit and other forms of personal security (which rely on a direct personal claim against a third person), as well as collateral or margin arrangements (which rely on delivery of assets, by way of security or title transfer).

As discussed further below, one of the principal goals of the ISDA working group drafting the Provisions was to establish a clearer, more "user-friendly", "plain English" document. "Margin" was chosen for use throughout the Provisions in preference to "credit support" or "collateral" (which is also commonly used) as a term with which market practitioners are comfortable. By the same token, "margin" is generally used in this Guide, for consistency with the Provisions; however references to "collateral" and "credit support" should be read as interchangeable with "margin".

Note that all three terms, "collateral", "margin" and "credit support", are intended to be generic references to arrangements intended to secure or support the obligations of one party (the party giving the collateral, margin or credit support) to the other party. None of these terms necessarily implies a particular legal basis for the arrangement. Instead, as noted above, the legal basis is chosen by the parties in the Supplement. Of course, that choice may in turn be affected by other relevant laws and regulations, particularly in the place of location of the margin assets, as discussed further below.

B. Background

In 1994 ISDA published the 1994 ISDA Credit Support Annex under New York law (the "New York Annex") for use in documenting bilateral margin arrangements between

2 But see discussion of this point at Part III.D below.

counterparties for transactions governed by an ISDA Master Agreement under New York law. The New York Annex was drafted for use with U.S. Dollar denominated margin only (there are no currency conversion provisions) and is based on creation of a New York law security interest in the margin provided. This form is described in detail in the User's Guide to the 1994 ISDA Credit Support Annex, which is available from ISDA.

In 1995 ISDA published two additional standard form credit support documents for use in documenting bilateral margin arrangements under English law between counterparties for transactions governed by an ISDA Master Agreement under English law. These documents are:

(1) the ISDA Credit Support Deed (Bilateral Form - Security Interest) (the "Deed"); and

(2) the ISDA Credit Support Annex (Bilateral Form - Transfer) (the "English Annex").

Each of these forms is a multi-currency form. The Deed creates a security interest (mortgage or charge) under English law in the margin provided, while the English Annex is based on transfer of title to the margin provided. The Deed, for purely technical reasons, is a stand-alone document, while the English Annex, like the New York Annex and the Supplement, is intended to be annexed to an ISDA Master Agreement. Each of these forms is described in detail in the User's Guide to the ISDA Credit Support Documents under English Law, which is available from ISDA.

In 1995 ISDA published the 1995 ISDA Credit Support Annex under Japanese law (the "Japanese Annex") for use in documenting bilateral margin arrangements under Japanese law between counterparties for transactions governed by an ISDA Master Agreement. The Japanese Annex combines two different legal approaches to the establishment of a margin arrangement under Japanese law, one based on creation of a Japanese law pledge and the other based on the creation of loan collateral, which, although apparently classified as a security interest, is comparable to the English law concept of title transfer collateral.[3] The Japanese Annex is drafted in the form of an Annex, although the User's Guide to that form indicates that it should "not [be] considered to be incorporated into an ISDA Master Agreement". Like the New York Annex, it is a single currency form for use only with Japanese Margin. The User's Guide to the 1995 ISDA Credit Support Annex (Japanese Law) is also available from ISDA.

The relationship of these forms (the "Credit Support Documents") to the Provisions is discussed in Part I.D of this Guide. As noted there, each of the Credit Support Documents remains available and may continue to be used.

The Provisions were developed to address concerns arising out of the period of market volatility in 1997 and 1998. As a result of experience gained at that time and subsequently, a consensus began to develop among market practitioners that:

(1) the timing of margin calls and returns should, ideally, be tighter;

(2) the timing of the dispute resolution procedures should, ideally, be tightened and the mechanism improved in various ways; and

3 See pp 9-11 of the User's Guide to the 1995 ISDA Credit Support Annex (Japanese Law). Similarly in Italy, a *pegno irregolare* (irregular pledge) is classified as a form of security interest under Article 1851 of the Italian Civil Code, but substantively appears to affect a transfer of title.

(3) the documentation should be simplified , shortened and ideally drafted in a more "plain English" style, to improve understanding and ease of use, both for existing market practitioners and their advisers and for counterparties new to collateralised trading.

Early in 1999, ISDA published the ISDA Collateral Guidelines, which outline basic principles of collateral management and summarise key risks, including documentation and legal risks. Later in 1999, ISDA published the 1999 Collateral Review, which reviewed in particular the experiences of collateral practitioners during the periods of market volatility in 1997 and 1998.

These studies, as well as the direct experience of collateral practitioners, suggested that a new generation of credit support documentation was desirable. The new documentation needed to be less complicated than the Credit Support Documents and better aligned with collateral management practice in the market. The timing cycles also needed to be amended to bring the provisions into line with the timing cycles in other key markets (for example, exchange-traded derivatives and repos).

In December 1999, ISDA, in consultation with collateral practitioner members, issued detailed instructions to drafting counsel, asking for a new form of margin documentation to be prepared, reflecting the following aims:

(1) to encourage development of common practices in relation to providing and managing collateral;

(2) to reduce the timing of margin calls and substitutions;

(3) to reduce the timing and improve the operation of the dispute resolution procedures;

(4) to simplify the documentation by reducing the amount of paper exchanged between the parties, using one document with elective provisions dealing with the two basic legal approaches (security interest and title transfer) and written in plain English; and

(5) to develop an open architecture for the new margin documentation, to permit it to be used with an Agreement not published by ISDA and to be used to collateralise the aggregate net exposure under two or more Agreements.

A number of drafts were produced, intensively reviewed by dedicated working groups in different parts of the world and available to all interested ISDA members at different times during the course of broad consultation periods. The Provisions were published in May 2001.

As with prior standard form documents published by ISDA, the Provisions in part reflect current market practice and in part are intended to improve it, even if such progress takes some time to achieve. The Provisions are also intended to promote market efficiency and stimulate growth by (a) making collateralised trades easier, quicker and therefore less expensive to document and (b) attracting new market participants with more straightforward and user-friendly documentation.

C. A new architecture for margin arrangements

The most striking innovation of the Provisions is the combination in one document of an integrated set of mark-to-market operational provisions with the different legal approaches and choices of governing law available in three out of the four Credit Support Documents. The English law security interest approach reflected in the Deed is not included in the Provisions. It could have been, but the drafting group felt that the Deed is not sufficiently widely used in the market to justify its inclusion.[4]

It should also be noted that, while Japanese law provisions are included in the Provisions for use in relation to Japanese Margin, this choice assumes that a primary choice has already been made of either the New York law security interest or English law title transfer approach to govern the overall margin arrangement.[5]

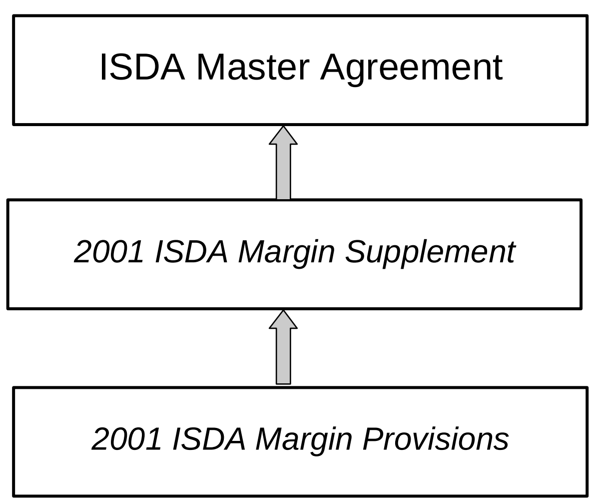
The combination of different possible governing laws in the Provisions raises some interesting questions, some of which are discussed in Part I.E below.

1. Architecture of the margin arrangement

The overall architecture of a margin arrangement based on the Provisions is shown in Figure 1.

Figure 1

Revised architecture for margin arrangements



4 The principal reason that the Deed is not currently widely used appears to be that, in contrast to the other three Credit Support Documents, the Secured Party (margin taker) under the Deed is not permitted to use the margin it holds. It is not allowed, for example, to re-sell, repo, re-pledge or otherwise dispose of securities held as margin. The reasons for this are set out in the User's Guide to the ISDA Credit Support Documents under English Law.

5 But see discussion of this point in Part III.D below.

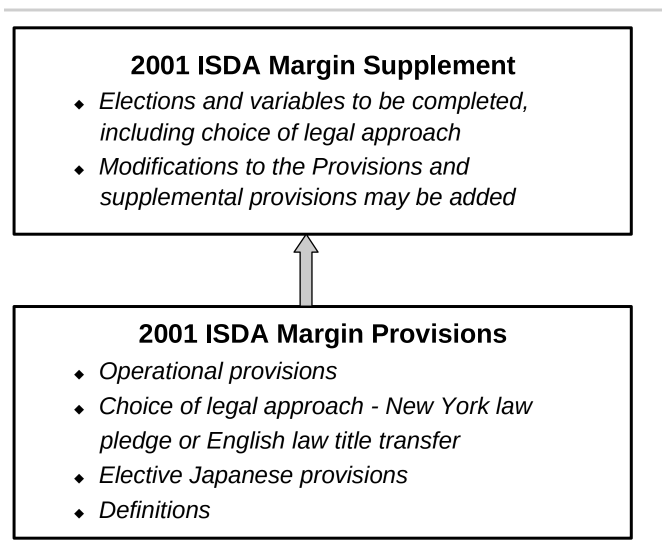
The Provisions are incorporated into a Supplement. This Supplement forms part of and is governed by the Agreement to which it relates. In practice, it will typically be physically annexed, at least where entered into at the same time as the related Agreement.[6]

2. Structure of the Supplement

The structure of the Supplement is shown in Figure 2.

Figure 2

Structure of the Supplement



The Supplement, as noted above, is the basic operative document of the margin arrangement. It:

(1) incorporates the Provisions; and

(2) includes the basic elections and other variables specified by the parties for their own margin arrangement, including the legal approach on which the arrangement is based, as well as any modifications to the Provisions and any supplemental terms.

This structure is, of course, similar to the structure of a Confirmation incorporating one of ISDA's standard booklets of Definitions. As in the case of a Confirmation, a Supplement, by its own terms, "supplements, forms part of, and is subject to, the ISDA Master Agreement" to which it relates.

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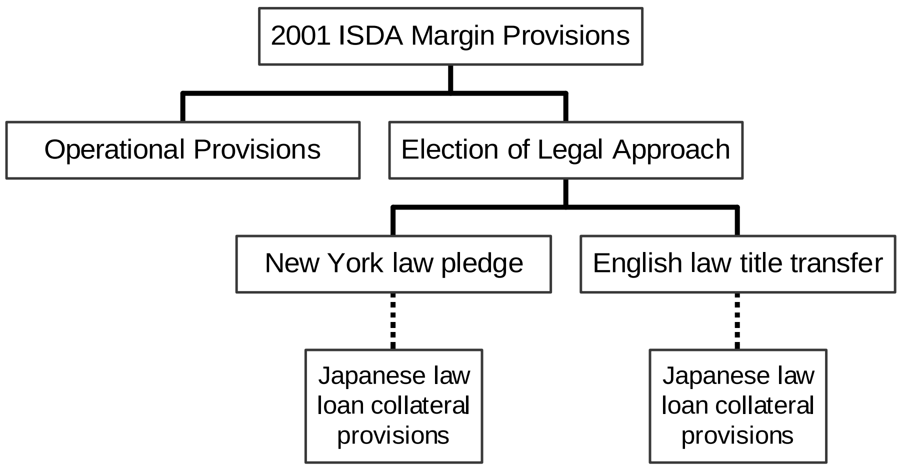
6 Entering into any margin arrangement after the agreement to which the arrangement relates potentially raises a risk of avoidance, at least for a period of time, under preference or similar rules under the bankruptcy or insolvency laws of many jurisdictions. In such circumstances, users are advised to consult their legal advisers to determine whether this risk arises in their case.

3. Structure of the Provisions

The structure of the Provisions is shown in Figure 3.

Figure 3

Structure of the Provisions



The Provisions may be broadly divided into two parts:

- the <u>operational provisions</u> setting out the mark-to-market mechanics of the margin arrangement, and

- the <u>elective legal provisions</u> establishing different possible legal bases for the arrangement.

There is also a set of defined terms, most of which relate to the operational provisions.

Part 1 of the Provisions sets out the operational provisions.

Parts 2, 3 and 4 set out the elective legal provisions. Parties must elect which legal approach and governing law will apply to their margin arrangement. If the parties wish to use a New York law security interest approach, they elect in the Supplement to incorporate Part 2 of the Provisions. If they wish to use an English law title transfer approach, they elect in the Supplement to incorporate Part 3 of the Provisions.

Part 5 of the Provisions sets out various definitions used in Parts 1 to 4 and in the Appendices to the Provisions. The Appendices include a recommended form of Supplement and various forms of Notice required or permitted under the Provisions. There is also an Annex setting out additional definitions applicable to margin subject to Article 8 of the New York Uniform Commercial Code.[7]

In addition to their choice of overall legal approach to govern the margin arrangement, the parties may, if they contemplate including Japanese Margin under the arrangement, elect in the Supplement to incorporate Section 4.1 of the Provisions.

ISDA contemplates that Part 4 may be amended or expanded in the future to include additional Sections setting out jurisdiction-specific provisions for margin located in other jurisdictions. As of the publication of the Provisions, the Japanese provisions were the only provisions that commanded a consensus in the drafting group. As noted in footnote 1 to Part 4 of the Provisions, if Part 4 is amended or expanded, ISDA will publish the revised Part 4 on its website, www.isda.org. Any such modification or expansion of Part 4 would not, however, affect a margin arrangement in effect at that time unless the parties agree expressly otherwise.

D. Relationship between the Provisions and the Credit Support Documents

1. Existing margin arrangements. Existing margin arrangements made using one of the current ISDA Credit Support Documents are not affected by the publication of the Provisions. Parties may wish to continue with such arrangements without amendment.

Parties currently using the New York Annex, English Annex or Japanese Annex loan collateral provisions have a couple of additional choices. They may, for example, if they so wish, amend and restate their current document as a Supplement incorporating the Provisions. A form of Amendment to achieve this is set out in Appendix A to this Guide.

For those parties not yet ready to use the Provisions but wishing to upgrade their current arrangement in certain ways, ISDA has published standard form amendments to the New York Annex and the English Annex in relation to:

(1) transfer timing;

(2) timing and operation of the dispute resolution procedure;

(3) addition of a Dispute Termination Event; and

(4) substitutions/exchanges.[8]

These standard form amendments reflect the substantive treatment of each of these issues in the Provisions, but, of course, using the terminology of the Credit Support Documents.

7 The purpose of these additional definitions is discussed in Part II.M of this Guide.

8 "Substitution" and "exchange" mean the same thing in this context. The latter term was used in the English Annex simply to emphasise that each transfer for this purpose is itself a transfer of title and not a transfer by way of security. As long as this is clearly understood by the parties, there is no difficulty using the word "substitution" in connection with an English law title transfer margin arrangement, and this is therefore the approach adopted, for simplicity, under the Provisions.

Parties may include one or more of these standard form amendments in their existing margin arrangement, either by:

(1) using a form of Amendment Agreement also published by ISDA for this purpose (available from the ISDA website, www.isda.org, under the 2001 ISDA Credit Support Protocol - Frequently Asked Questions section); or

(2) adhering to the 2001 ISDA Credit Support Protocol (the "Protocol") that ISDA has established to allow parties to effect rapidly and efficiently, via the internet, a series of bilateral amendments to their existing margin arrangements with all other parties adhering to the Protocol and making the same elections.

The protocol approach has been previously used successfully in relation to European economic and monetary union ("EMU") issues and the introduction of the euro. For details, see the ISDA website at www.isda.org.

2. New margin arrangements. In relation to new margin arrangements, parties effectively have the same three possibilities, namely, to use:

(1) one of the existing Credit Support Documents;

(2) a New York Annex or English Annex, amended in relation to transfer timing, dispute resolution and/or substitutions, as described above; or

(3) a Supplement, incorporating the Provisions.

The Amendment set out in Appendix A to this Guide may be used to add a Supplement to an existing ISDA Master Agreement.[9]

3. Comparison of the Provisions with the Credit Support Documents. To assist users of the current Credit Support Documents in gaining familiarity with the Provisions and evaluating the principal substantive changes reflected in the Provisions, various comparative summaries are set out in Appendices F, G and H.

Appendix F sets out in tabular form a comparison of the terminology used in the Provisions with the terminology used in the New York Annex and the English Annex. It can be seen from that table that by and large the same concepts are used in the Provisions as in the Credit Support Documents, although careful attention should be paid to the Note accompanying the table. There are, of course, some new concepts, including most notably the concept of Lock-up Margin, discussed in Part II of this Guide below.

Appendices G and H set out in somewhat more detail a comparison of the key elements of the Provisions with the New York Annex and the English Annex, respectively.

9 But see footnote 6 in this regard.

For those less familiar with the Credit Support Documents, it may be worth recalling a few fundamental principles that are common to the Provisions and the Credit Support Documents:

(1) each document is designed to secure or support the net exposure of the margin taker to the margin provider under the ISDA Master Agreement (and/or, in the case of the Provisions, any other Agreement(s) specified in the Supplement);

(2) each document is bilateral, in that either party may be a margin taker or margin provider over time, as the net exposure changes in accordance with market movements;

(3) each document provides for periodic mark-to-market valuation of the net exposure and the margin provided with a view to ensuring (subject to agreed thresholds, minimum transfer amounts, haircuts, rounding and so on) that the net exposure is adequately covered by the margin, that additional or "top-up" margin is delivered, if necessary, and that excess margin is returned to the relevant provider; and

(4) each document is designed for use only with cash and/or securities as margin.

In relation to (1), to avoid being under-margined at the time of a default, each party should ensure that close-out netting under the ISDA Master Agreement or (in the case of the Provisions) other relevant Agreement is effective against the other party in each relevant jurisdiction.[10] ISDA has collected legal opinions on the enforceability of close-out netting under the ISDA Master Agreement from thirty-six jurisdictions around the world (as of the date of publication of this Guide).[11] These are available only to members of ISDA. Further information is available on the ISDA website, www.isda.org.

In relation to (2), it is possible for a party to be both a margin provider and a margin taker at the same time, for example, where there has been a switch in the net exposure and overlapping settlement periods or where each party is holding initial margin.[12] In such a case, a party would be acting in each capacity separately in relation to different pools of margin. This should not cause any problem in practice, provided that the relevant pools of margin are adequately identified in the records of each party. See further the discussion of the definitions of "Taker" and "Provider" in Part II of this Guide below.

In relation to (3), the mark-to-market mechanics of the Provisions are discussed in some detail in Parts II and III of this Guide below and, in relation to the Credit Support Documents, in the various User's Guides to those documents published by ISDA.

10 Which jurisdictions are relevant is a matter for the judgement of the parties and will vary according to the circumstances. Bank regulatory authorities generally consider that the relevant jurisdictions are the jurisdiction of the governing law of the relevant master agreement (in the case of the ISDA Master Agreement, New York or England), the jurisdiction of the law governing each transaction under the master agreement (this will normally be the same as that of the master agreement, but might differ, for example, if a "sweep-in" clause or "bridge" has been included in the master agreement), the jurisdiction of organisation of each party and, in the case of a multibranch party, the jurisdiction of location of each branch. A "sweep-in" clause or "bridge" is a clause or clauses under which transactions originally entered into outside the relevant master agreement are deemed to be governed by the master agreement for purposes of the early termination and close-out netting provisions. A limited example of such a clause is the ISDA BBAIRS/FRABBA Bridge, but more widely drafted "sweep-in" clauses or "bridges" are sometimes included in Part 5 of the Schedule to the ISDA Master Agreement. Such a clause requires careful drafting to ensure that it is clear, certain and effective on insolvency or other default.

11 Any ISDA member seeking to rely on an ISDA netting opinion should satisfy itself that the opinion is reasonably up-to-date and that its counterparty is of a type and the transactions to be entered into are of a type falling within the scope of the opinion. Certain types of entities, for example, insurance companies, are not covered by many of the ISDA netting opinions.

12 "Initial margin" is used here in its commercial sense. Under a Supplement incorporating the Provisions, this could occur where each party holds Lock-up Margin.

In relation to (4), neither the Credit Support Documents nor the Provisions are designed for use with assets other than cash and securities. Other types of assets used in secured transactions include intangible assets such as commercial receivables, contractual obligations, intellectual property and goodwill as well as tangible assets such as land, buildings, equipment, vehicles, precious metals, commodities and other goods and chattels. It would be unusual to use tangible assets of this type in a financial markets context, but in certain circumstances intangible assets might be used. The parties would need to take appropriate legal advice in relation to any additional classes of margin assets they might wish to include under a Supplement, and additional drafting would almost certainly be required to effect this.

4. ISDA's collateral opinions. ISDA has obtained opinions on the enforceability of the New York Annex, the English Deed and the English Annex from local counsel in a number of jurisdictions (twenty as of the date of publication of this Guide, with ten more commissioned and currently in preparation).

ISDA intends in due course to ask local counsel in each of these jurisdictions to extend their opinions to cover the Provisions. As with the netting opinions, the collateral opinions are available only to members of ISDA. Further information is available on the ISDA website, www.isda.org.

Any ISDA member seeking to rely on an ISDA collateral opinion should satisfy itself that the opinion is reasonably up-to-date and that its counterparty is of a type and the transactions to be entered into are of a type falling within the scope of the opinion. In some cases for certain types of margin arrangements with certain types of counterparty and/or relating to certain types of margin assets, there are additional actions to be taken or formalities to be complied with to ensure the effectiveness of the arrangement. Such actions or formalities are sometimes referred to as "perfection" requirements. Opinions should be reviewed carefully in this regard, and local counsel should be consulted where necessary.

Which jurisdictions should be investigated by parties to a margin arrangement is a matter of judgement for each party, but at a minimum a party will want to ensure that the arrangement is effective:

(1) in the counterparty's home jurisdiction (which would generally be where it is incorporated or where it has its main headquarters and/or principal assets) in the event of the counterparty's insolvency there; and

(2) in each jurisdiction where margin assets that may be delivered under the margin arrangement are located.

E. Governing law issues

It is perhaps inevitable, given the increasing globalisation of the financial markets, that cross-border trading relationships, and therefore cross-border margin arrangements, are common. In Europe and Asia, it is perhaps fair to say that cross-border margin arrangements are the rule rather than the exception.

Margin arrangements bring an additional "connecting factor" in private international law terms to a trading relationship, in that the law of the place of location of the margin assets is relevant to the effectiveness of the arrangement, even if there is no other connection to the jurisdiction other than the presence of the margin assets themselves.

The possible jurisdictions relevant to a margined trading relationship under an Agreement include:

(1) the jurisdiction of the governing law of the relevant Agreement (in the case of an ISDA Master Agreement, New York or English law);

(2) the law governing each transaction under the Agreement[13];

(3) the jurisdiction of the governing law of the margin arrangement (in the case of the Provisions, the possibilities being New York or English law or, in relation to Japanese Margin, Japanese law);

(4) the jurisdiction of organisation of each of the parties, for a variety of purposes, but most notably for the effectiveness of the Agreement and the margin arrangement on the insolvency of a party, as well as issues of its corporate capacity (legal power) and authority to enter into the Agreement, margin arrangement and each transaction;

(5) in the case of a multibranch party, the jurisdiction of location of each branch of that party;

(6) the jurisdiction of location of the margin assets;[14] and

(7) each jurisdiction where obligations of a party are to be performed under the Agreement, margin arrangement or any transaction.

Other jurisdictions may also be relevant in specific cases. This gives rise to a potentially bewildering set of permutations. In practice (if not always in theory), legal advisers can generally work out a satisfactory answer to the question of which law governs a particular question that might arise in relation to the margined trading relationship between the parties.[15] Because different laws are generally relevant for different purposes, it is perhaps not surprising that sometimes it may be considered advisable to have different laws governing different parts or aspects of the trading relationship. Of course, this is inevitable in any event under private international law principles,[16] but here we mean that it may be advisable in certain circumstances for the parties <u>to make an express choice</u> in their contractual arrangements to have different laws apply to different parts of their documentation.

The possibility of parties choosing to have different laws govern different parts of the same contract, sometimes referred to as *dépeçage*, is recognised in private international law.[17]

13 If the law governing each transaction is different from the governing law of the relevant Agreement, see footnote 10.

14 The law of the place of location of assets generally governs the proprietary aspects of a transfer of those assets and the rights of third parties, including the priority of claims as between the transferee and a third party. This includes the proprietary aspects of a transfer by way of security and therefore "perfection" (in the terminology of common law lawyers) of the security interest. In the Latin terminology beloved of private international law specialists, this law is often referred to as the *lex rei sitae* (in civil code countries) or the *lex situs* (in common law countries).

15 Some questions are notoriously difficult. For example, the question of where securities held by intermediaries in indirect holding systems are located for purposes of determining the *lex rei sitae* is currently (at the date of publication of this Guide) being addressed by a working group of the Hague Conference on Private International Law as well as by the European Commission in the context of its proposed Directive on financial collateral arrangements.

16 Private international law rules are sometimes referred to as conflict of laws rules. While for theoretical purposes the two phrases may be somewhat different in scope, for present purposes they may be used interchangeably.

17 See, for example, Article 3(1) of the Rome Convention of 1980 on contractual obligations, as most recently amended. The topic is discussed in the context of the Rome Convention in *Cheshire and North's Private International Law* (13th edition, Butterworths 1999) at pp 553-554 and *Dicey and Morris on Conflict of Laws* (13th edition, Sweet & Maxwell 2000) at pp 1211-1214.

There are some theoretical issues involved in such an approach. In addition, it should be borne in mind that in the event of a dispute, there could be some practical inconvenience, delay and/or additional expense entailed by having different parts of the contractual arrangements of the parties governed by different laws. Nonetheless, broadly speaking, it should be possible in principle for the parties to choose different laws to govern different parts of the same contract, to be confirmed on a case by case basis by each party with its own legal advisers.

Below, the three most common sets of mixed governing law questions are briefly considered.

1. Different governing law for a margin arrangement and a related Agreement. In relation to the Credit Support Documents, the question has sometimes arisen whether it is possible to use a New York Annex with an ISDA Master Agreement governed by English law or an English Annex with an ISDA Master Agreement governed by New York law. In principle, each should be possible, although users should, as noted above, confirm this with their legal advisers.

By the same token, therefore, it should in principle be possible to adopt the New York law security interest approach in a Supplement used with an English law governed ISDA Master Agreement (or other English law governed Agreement), or vice versa.

Of course, where the parties elect to have Section 4.1 of the Provisions apply to Japanese Margin, this will be an exception to the primary governing law of the Supplement, which, as noted above, will be either New York law or English law.

2. Different governing law for each party as margin provider. A further question that sometimes arises is whether it is possible to have one legal approach and governing law for margin provided by one party and another legal approach and governing law for margin provided by the other party. For example, under an English law governed ISDA Master Agreement between a U.S. bank headquartered in New York and a U.K. bank headquartered in London, would it be possible to have the New York law security interest approach apply to margin provided by the U.S. bank and the English law title transfer approach apply to margin provided by the U.K. bank?

In principle, the answer is yes, but users should confirm this with their own legal advisers in relation to the facts of each situation. Also, it should be noted that some additional drafting would be necessary to give effect to this mixed governing law approach. Probably, it would be most convenient to amend Paragraph 1 of the Supplement to achieve this.

3. Different governing law for different types of margin assets. Finally, some members of the ISDA working group drafting the Provisions raised the question whether it is possible in principle to have different legal approaches apply to different types of margin assets regardless of which party is the margin provider. Of course, the Provisions already reflect this possibility with the inclusion of the Japanese loan collateral provisions in Section 4.1 of the Provisions. As noted above, ISDA may modify and/or expand Part 4 of the Provisions over time to include other jurisdiction-specific provisions.

In the meantime, it should in principle be possible to have the New York security interest approach apply to one set of margin assets (for example, U.S. Treasuries) while the English law title transfer approach applies to other margin assets (for example, European government securities), regardless of which party is the margin provider. Again, local legal advice should be sought to confirm this, including local advice where the margin assets are located.

The practical issues noted above would also be relevant and additional drafting would be required in the Supplement to clarify which legal approach and governing law apply to each type of margin asset. Footnotes 1 and 2 to Appendix A of the Provisions give guidance on the drafting necessary to achieve this.

II. OPERATIONAL PROVISIONS

A. Overview

Part 1 of the Provisions sets out the basic mark-to-market mechanics of a margin arrangement as well as related commercial terms, including: timing of transfers; margin-related events of default; dispute resolution procedures; substitutions of margin; pass-through to the margin provider of income and other rights on securities taken as margin; interest on cash margin; expenses; default interest; demands; and notices.

The discussion below roughly follows the order of Part 1 of the Provisions, but with some grouping of common topics (for example, issues relating to valuation) for the sake of clarity.

B. The Taker and the Provider

As noted in Part I of this Guide, a Supplement incorporating the Provisions is a bilateral form under which a party may, at different times during its trading relationship with the other party, be a margin provider or a margin taker.

In principle, the margin taker (referred to as the Taker in the Provisions) on any Valuation Date is the party with a net exposure to the other party (referred to as the Provider in the Provisions). The terms "Taker" and "Provider" were chosen as terms compatible with each of the legal approaches set out in Parts 2, 3 and 4 of the Provisions.

More precisely, "Taker" is defined in the preamble to the Provisions as a party:

(1) holding Margin Received;[18]

(2) demanding Eligible Margin;

(3) demanding Lock-up Margin; or

(4) receiving a Substitution Notice.

Note that this definition is functional and relative. It is functional and relative in the sense that the term has different meanings depending on the purpose for which it is being used. Hopefully, it can be seen intuitively, however, that the Taker is the party, broadly speaking, with an actual or potential credit exposure to the other party under the ISDA Master Agreement or other Agreement(s) collateralised by a Supplement incorporating the Provisions.

"Provider" is defined negatively and relatively as the party that is not the Taker. Again, hopefully, its essential meaning is clear intuitively.

This approach to the drafting of the terms "Taker" and "Provider", which is similar to the approach taken in the Credit Support Documents, is necessary because of the bilateral nature of the arrangement and the fact that the net exposure can change over time and, in fact, can at times change rapidly. It could be, for example, that because of overlapping settlement periods or where

18 The term "holding" is used here, and in the preamble to the Provisions, in its commercial sense. If the English law title transfer approach applies, the Taker does not "hold" any assets of the Provider, but merely has a conditional contractual obligation to the Provider equal to the value of the margin it has previously received and in relation to which it has not yet delivered equivalent margin to the Provider.

each party is required to provide Lock-up Margin, a party might be a Taker in relation to one pool of margin assets and a Provider in relation to another.

The drafting of the Provisions reflects these possibilities. It is, of course, the responsibility of each party to ensure that its own collateral management system can effectively cope with rapid changes in mark-to-market exposure, differing settlement periods for different types of assets and the fact that a party may act in different capacities in relation to different pools of margin assets.

Note that it is also possible, given the above definition of "Taker", that neither party is a Taker or a Provider at certain times during their margined trading relationship.[19]

C. Margin Transfer Obligations

Section 1.1 of the Provisions is, in effect, the heart of the Provisions, since it sets out the fundamental delivery obligations of the Provider and the return obligations of the Taker.[20]

The Provisions, broadly speaking, allow for the possibility of initial margin and variation margin to be required under a Supplement:

(1) initial margin under the Provisions is referred to as "Lock-up Margin";[21] and

(2) variation margin is referred to as a "Delivery Amount" when it is additional margin being provided to the Taker and a "Return Amount" when it is excess margin being returned to the Provider.

In principle, the variation margin provisions are intended to ensure that the net exposure of the Taker to the Provider on any Valuation Date (subject to various adjustments discussed below) is covered by margin. Initial margin is intended to provide a measure of protection against a possible increase in the Taker's net exposure to the Provider before the next Valuation Date and delivery of further variation margin. In other words, variation margin is intended to cover current exposure and initial margin is intended to cover possible future exposure.

The foregoing is the essential structure of any mark-to-market margin arrangement and will be familiar to participants in financial markets other than the privately negotiated derivatives markets, including those active on organised markets (exchanges) for securities, commodities and/or derivatives.

1. Lock-up Margin. Lock-up Margin, as noted above, is effectively initial margin. The Provisions do not specify how Lock-up Margin is to be calculated. The form of Supplement in Appendix A to the Provisions suggests that the Lock-up Margin should be specified in relation to each party as a single fixed amount in the Base Currency. The parties are free, however, to specify Lock-up Margin in some other way, if they prefer. One alternative would be to specify

19 This could be the case, for example, when Lock-up Margin is not required under the Supplement, neither party is then holding Margin Received (and therefore Substitution Notice is not relevant) and neither party is entitled to demand Eligible Margin as a result of the fact that neither party has a net exposure (relatively unlikely) or neither party has a net exposure exceeding the Threshold or the Minimum Transfer Amount.

20 The word "return" is used in this sentence, and elsewhere in this description of Part 1 of the Provisions, in its commercial sense. Under the title transfer approach, the Taker is not obliged literally to return any assets it has received, but is only obliged to deliver to the Provider equivalent fungible assets.

21 The concept of "Additional Margin Amount", discussed below in the Guide, is arguably akin to initial margin in purpose, but forms part of the variation margin mechanics of Delivery Amounts and Return Amounts. Lock-up Margin does not form part of the variation margin mechanics of Delivery Amounts and Return Amounts.

Lock-up Margin as the sum of amounts (in the Base Currency) specified for each Transaction as a fixed amount (possibly subject to periodic adjustment) or determined for each Transaction by reference to a formula.

Note also that Lock-up Margin could be linked to a credit-related event. For example, if a potential Provider's senior unsecured debt obligations are rated by a recognised rating agency, the Lock-up Margin requirement could arise, or be increased, if the rating is lowered below an agreed level or withdrawn altogether. If using such a provision, the potential Taker will wish to consult its legal advisers to ensure that such a link is not vulnerable to preference (or similar) rules under the insolvency law applicable to the other party.

<u>Each delivery of Lock-up Margin must be made without offset, set-off or payment netting against any other delivery of margin. Note also that if Lock-up Margin is specified in the Supplement in relation to a party, the other party may demand delivery of that Lock-up Margin even if it has no Exposure to the party at that time. As noted above, this also means that each party may be holding Lock-up Margin and therefore be a Taker for this purpose, even though only one of the parties (typically) would be the Taker at any one time in relation to the variation margin requirements discussed in the next section below.</u>

Under Section 1.1(c)(ii), the Provider of Lock-up Margin may demand return of Lock-up Margin in any circumstances specified in the Supplement. For example, if at any time the Provider does not have any present or future, absolute or contingent obligations to the Taker (because, for example, all prior Transactions have matured, and no amounts remain due and unpaid), then the Lock-up Margin (or fungible equivalent assets) may be returned to the Provider. Once the specified circumstances no longer apply (because, for example, a new Transaction has been executed), then the Provider must provide Lock-up Margin once again.

Note that while a Taker may have no Exposure (that is, no current mark-to-market exposure) to a Provider, it will wish to retain Lock-up Margin as long as it has potential future exposure. The Supplement will therefore normally only permit return of Lock-up Margin to the Provider where there is no current or potential future exposure of the Taker to the Provider. As soon as a new Transaction is entered into, potential future exposure arises (unless, for example, the new Transaction is an option transaction under which the Provider pays a single upfront premium and has no further obligations).

Another example of circumstances where return of Lock-up Margin might be demanded by a Provider could be where the senior unsecured debt obligations of the Provider are upgraded by the rating agencies to an agreed level. If subsequently the rating falls below the agreed level, the Taker could once again demand delivery of new Lock-up Margin. Another example, suggested in the form of Supplement in Appendix A to the Provisions, would be where the Taker's Exposure falls below a certain level. If the Taker's Exposure subsequently increases above the specified level, the Taker could once again demand delivery of new Lock-up Margin.

Finally, note that neither Minimum Transfer Amount (discussed below) nor any rounding convention specified in the Supplement applies to transfers or returns of Lock-up Margin.

2. Delivery Amounts and Return Amounts. Delivery Amounts and Return Amounts, as noted above, are effectively variation margin. The provisions for determining these amounts are, of course, more complicated than for Lock-up Margin, because essentially this mechanism is intended to track the fluctuations in exposure and margin value occurring on each Margin Business Day.

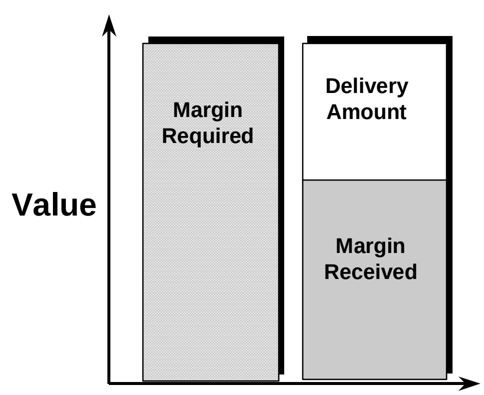
The general principle is that margin calls and returns are determined on Valuation Dates on a mark-to-market basis. The assumption in the Provisions is that each Margin Business Day is a Valuation Date, but the parties may vary this if they wish. Daily margining, however, is the market norm.

The party with a net exposure to the other party on any Valuation Date is the Taker under the Provisions. It may calculate the amount of margin it is entitled to take under the Provisions (the Margin Required) and the value of the margin it has taken and not yet returned (the Margin Received).

If the Margin Required exceeds the Margin Received, then the Taker may demand additional margin. This additional margin amount is called the Delivery Amount. It is sometimes referred to in the market as "top-up" margin. See Figure 4. The Provider must deliver an amount equal to or exceeding this amount.

Figure 4

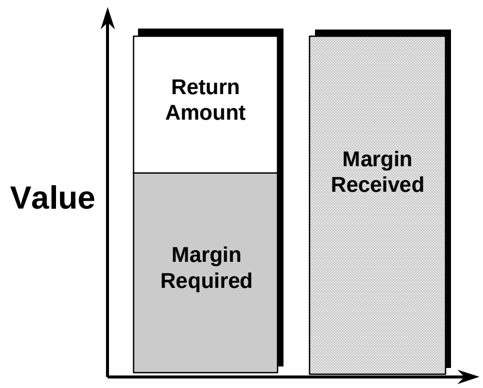
Calculation of Delivery Amount (simplified)



If the Margin Received exceeds the Margin Required, then the Provider may demand that some or all of the excess margin (or equivalent fungible assets) be returned. This excess margin amount is called the Return Amount. See Figure 5. The Taker is obliged to return equivalent margin in an amount as close as practicable to the Return Amount, but is never obliged to exceed it.

Figure 5

Calculation of Return Amount (simplified)



Appendix B sets out a detailed example of the calculation of Delivery Amount and Return Amount.

Note that in either case the party entitled to call for a delivery is the Calling Party under the Provisions, and the other party is the Call Recipient. These terms are important for other purposes, most notably the dispute resolution procedures of Section 1.6.

Note also that in each case the delivery must be demanded by the Calling Party "on or promptly following a Valuation Date". In other words, there is no automatic movement of margin under the Provisions. If no demand is made in relation to a Valuation Date, then margin does not move.

Remember that Margin Required is, effectively, the *net exposur*e of the Taker, after certain adjustments (discussed below); and Margin Received is, effectively, *margin held by the Taker*. The valuation of net exposure for purposes of determining the Margin Required is discussed in the next section below, followed by a section discussing the valuation of Margin Received.

3. Minimum Transfer Amount. Users should note that an obligation to deliver variation margin arises under Section 1.1(a) or (b) of the Provisions in relation to a Valuation Date only if the Delivery Amount or the Return Amount, as the case may be, exceeds the transferring party's Minimum Transfer Amount. The Minimum Transfer Amount for each party, which may be specified in Paragraph 5 of the Supplement, is intended to be set at a level that ensures that margin only moves when the amount is large enough to justify the transaction costs and inconvenience involved. In other words, it will generally be set high enough to eliminate frequent small margin movements reflecting normal day-to-day fluctuations in exposure and/or the value of margin held.

The Minimum Transfer Amount will also often reflect the credit quality of the party as a Provider. The lower the credit quality, the lower the likely Minimum Transfer Amount.

Minimum Transfer Amount is another term (like Threshold, Lock-up Margin and Additional Margin Amount) that may be linked to a ratings downgrade (or other credit-related event) in relation to a party as a Provider. On the occurrence of such an event, the Minimum Transfer Amount could be specified to fall to a small number or even zero. As noted above, parties will wish to confirm with their legal advisers that such a link does not give rise to difficulties under preference (or similar) rules arising under the insolvency law applicable to the other party.

As noted above, Minimum Transfer Amount does not apply to transfers of Lock-up Margin.

4. Rounding. Finally, parties may establish a rounding convention to avoid the need to deliver variation margin under Section 1.1(a) or (b) in an amount that is otherwise uneven or difficult to obtain in the precise amount determined (because, for example, certain securities trade in round "lots" or round multiples of their notional amount). If no rounding convention is specified, there is no rounding (in other words, there is no "fallback" rounding convention).

The parties may specify a rounding convention by, for example, specifying that either: (a) a Delivery Amount or Return Amount is rounded down to the nearest integral multiple specified; or (b) a Delivery Amount is rounded up and a Return Amount is rounded down to the nearest integral multiple specified. Parties would not ordinarily specify that both Delivery Amounts and Return Amounts are to be rounded up, as this could create conflicting obligations to transfer collateral and result in a Taker being undermargined.

While the parties may use a rounding convention as an alternative to a Minimum Transfer Amount (as both rounding and Minimum Transfer Amounts are, in essence, adjustments made to ease operational difficulties), most market participants maintain that this is not ideal from an operational perspective.

If, however, parties wish to use the rounding mechanism for this purpose, they could, for example, specify that (i) Delivery Amounts and Return Amounts below a specified level would be rounded down to zero and (ii) Delivery Amounts above that level would be rounded up and Return Amounts above that level would be rounded down, in each case to the nearest integral amount specified by the parties. In this way, market participants would obtain the same "minimum" that using a Minimum Transfer Amount would provide, without having to specify a separate rounding convention to eliminate uneven Delivery Amounts or Return Amounts.

As noted above, rounding does not apply to transfers of Lock-up Margin.

D. Determination of Margin Required

The Margin Required on a Valuation Date is:

(i) the Taker's <u>Exposure</u> on that Valuation Date as of the Valuation Time;

plus

(ii) the <u>Additional Margin Amount applicable to the Provider</u>, if any,

minus

(iii) the <u>Additional Margin Amount applicable to the Taker</u>, if any, *minus*

(iv) the Provider's Threshold.

Note that each of these elements needs to be expressed in a single currency in order for this formula to make sense as a determination of adjusted credit exposure. Each of the Exposure, Additional Margin Amount and Threshold is an amount expressed in the Base Currency, which is a freely available currency specified as such in Paragraph 3 of the Supplement.

Let us look at each of these elements in turn.

1. Exposure. The Taker's Exposure is, in effect, the amount that the Taker would be owed under Section 6(e) of the ISDA Master Agreement (or comparable provision of any other Agreement(s) collateralised by the Supplement) if an Early Termination Date (or Close-out Date under any other Agreement(s)) were designated or deemed to occur on that Valuation Date as of the Valuation Time. That makes sense, as that is the Taker's credit exposure to the Provider at that time on that day as far as the relevant Agreement is concerned.

If the Supplement relates to the ISDA Master Agreement, Exposure is determined as though a Termination Event had occurred with one Affected Party, but using mid-market valuations in relation to Transactions hypothetically terminated.

Clearly, where more than one Agreement is collateralised by a Supplement, the Exposure is the net balance of the net exposure determined under each Agreement. Parties must ensure, however, that their aggregate exposure under all of the Agreements taken together is, indeed, net. This may require the use of some form of set-off arrangement, for example, under a so-called "master master" or "umbrella" agreement.[22]

An important innovation in the Provisions is that the Supplement in Paragraph 2 permits the parties to exclude certain Transactions from the calculation of Exposure. This creates an economic effect similar to having only some of the Transactions under an Agreement collateralised.

It is important to note, however, that in the event of a default all of the Margin Received then held by the Taker is available to satisfy all of the relevant Obligations, up to the value of the Margin Received. In the case of the ISDA Master Agreement, in particular, this is crucial. Upon the designation or deemed occurrence of an Early Termination Date, Section 6(c)(ii) of the ISDA Master Agreement discharges all of the obligations of the parties under individual Transactions. Instead, an amount is due under Section 6(e), the close-out provision. The close-out amount is determined on a net basis, and there is no clear method for determining which "part" of that net amount may be allocated to the "collateralised" Transactions and which "part" may be allocated to the "non-collateralised" Transactions. This should come as no surprise, as it is a natural consequence of the single agreement created by the ISDA Master Agreement.[23]

22 One example of such an agreement is the Cross-Product Master Agreement published in February 2000 by The Bond Market Association. Such agreements are typically based on contractual set-off, rather than close-out netting as exemplified by the ISDA Master Agreement. Hence, it may be accurate to refer to such an agreement as a "master agreement", but it is less accurate to refer to such an agreement as a "netting agreement". The fact that such agreements are generally based on contractual set-off rather than close-out netting in the strict sense makes an important difference to the insolvency law analysis of the agreement in a number of jurisdictions. In other words, in some jurisdictions a close-out netting agreement such as the ISDA Master Agreement may fall within the netting legislation, whereas an "umbrella" or "master master" agreement may not.

23 See the more detailed discussion of this point in the User's Guide to the ISDA Credit Support Documents under English Law at pp. 16-17.

2. Additional Margin Amount. The Additional Margin Amount applicable to the Provider is an add-on to the Exposure of the Taker that is intended to cover a possible increase in the Exposure before the next Valuation Date. In this regard, it is arguably more akin to initial margin than variation margin. Mechanically, however, it is part of the calculation of Margin Required.

Note that although the Additional Margin Amount applicable to the Provider is added to Exposure, the Additional Margin Amount applicable to the Taker is subtracted from the Exposure. So, unlike Lock-up Margin, Additional Margin Amounts are offset or netted.

Clearly, if the Additional Margin Amount applicable to each party is the same, then the net effect on the Margin Required is zero.

As in the case of Lock-up Margin, there are various ways of specifying Additional Margin Amounts. Typically, the Additional Margin Amount is specified as a single fixed amount in the Base Currency or, on a formula basis, as the sum of amounts determined per Transaction. The amount per Transaction would, in turn, be specified as a fixed amount in the Base Currency or determined according to a formula. It would also be possible to specify zero as the Additional Margin Amount in relation to one or both parties.

Note that the specification of Additional Margin Amounts could be linked to a downgrade of the rating of the senior unsecured debt obligations of a party (or some other credit-related event), so that the Additional Margin Amount only applies (or is increased) on the occurrence of the downgrade (or other event). In such circumstances, each party as a potential Taker of Additional Margin Amounts will want to ensure that such a link is not vulnerable to preference (or similar) rules under the insolvency law applicable to the other party.

3. Threshold. The final element in the calculation of the Margin Required is the Threshold. This is, in effect, an amount of net credit exposure that a party is willing to accept to the other party before it requires margin to be provided. Accordingly, Margin Required only arises if the Exposure, adjusted by the Additional Margin Amounts (if any), exceeds the Threshold. The Threshold is sometimes referred to commercially as the "permitted unsecured risk".

As with Lock-up Margin and Additional Margin Amounts, the Threshold may be linked to a ratings downgrade or similar event, but the effectiveness of this on the insolvency of the other party should be checked with the party's legal advisers.

4. Calculation of Margin Required.

In contrast to the definition of "Credit Support Amount" in the Credit Support Documents (which is the term equivalent to "Margin Required"), the Provisions do not state explicitly that if the calculation of Margin Required results in a negative number, then it is deemed to be zero. For the avoidance of doubt, parties may wish to amend the definition of "Margin Required" to add at the end the following proviso: "provided, however, that the Margin Required will be deemed to be zero whenever the calculation of Margin Required yields a number less than zero".

Finally, note that under Section 1.5 of the Provisions, for purposes of determining Margin Required, Exposure will be determined as of the Valuation Time, which is defined in Section 5.50 of the Provisions to mean 5:00 p.m. in the "relevant market" for each Transaction on the Margin Business Day immediately preceding the relevant Valuation Date. In other words, Exposure is to be determined by determining the mark-to-market value of each of the Transactions (or perhaps groups of Transactions on a portfolio basis, as permitted under the ISDA Master Agreement) at or about the close of business in the relevant market(s) on the prior Margin Business Day.

Note that judgement will need to be exercised by a party in deciding what the relevant market is for purposes of determining the Valuation Time. Depending on the circumstances, reasonable persons may differ in making this determination in relation to the same set of facts. Section 1.10(f) applies here, as elsewhere, in requiring the determining party to act in good faith and in a commercially reasonable manner.

E. Valuation of Margin Received

Under Section 1.1 of the Provisions, for purposes of determining the applicable Delivery Amount or Return Amount in relation to a Valuation Date, the Margin Required is compared to the Value of the Margin Received on the Valuation Date and, pursuant to Section 1.5, as of the Valuation Time.

The meaning of Valuation Date is discussed above. Valuation Time is the same as for the determination of the Margin Required, in other words, 5:00 p.m. in the relevant market on the Margin Business Day immediately preceding the Valuation Date. In other words, roughly speaking, margin is valued as at close of business on the prior Margin Business Day for the market on which such margin assets are typically traded.

"Value" is defined in Section 5.51 differently depending on the type of asset being valued, being:

(a) in relation to Cash, the Value is the face amount of the Cash multiplied by the Valuation Percentage;

(b) in relation to securities, the bid price obtained by the Calling Party (see above) multiplied by the nominal amount of the security (plus accrued and so far unpaid income if not already included in the price) and multiplied again by the Valuation Percentage; and

(c) in relation to margin assets delivered to the Taker that are not Eligible Margin, the Value is deemed to be zero (so there is no point, as far as the Provider is concerned, in delivering such assets!).

In the case of (a) and (b), the Value is to be determined in the Base Currency, in order to make a proper comparison with the Margin Required, all of the elements of which, as discussed above, are expressed in the Base Currency.

Note, in relation to (b), that the bid price of the relevant security should include accrued income, but without double-counting. The Calculation Agent should know the basis on which the bid price is quoted and, if it does not include accrued income, the Calculation Agent should make the necessary adjustment to the price for purposes of the valuation.

Valuation Percentage is an important concept. Roughly speaking, it is the "haircut" applied to margin assets. In other words, it is a mechanism for deliberately undervaluing margin assets by an agreed percentage in order to ensure that the actual value of margin assets received is greater than the exposure to which those margin assets relate. In other words, it is a form of over-margining akin to the use of Additional Margin Amounts, the difference being that the latter concept affects the amount of Margin Required (increasing it by the Provider's Additional Margin Amount and decreasing it by the Taker's Additional Margin Amount), while Valuation Percentage (if less than 100 per cent) lowers the valuation of the Margin Received. (Hopefully, it is clear that each mechanism therefore increases the gap between Margin Required and Margin Received and therefore increases the Delivery Amount or decreases the Return Amount.)

Another way of looking at Valuation Percentage is that it reflects the fact that a Taker, in a default situation, may not be able to realise fully the value of the margin assets it has on hand, partly because the market value of those assets may decline between the time they are received and the time they are liquidated, for example, by sale into the market and partly because of the transaction costs that may be involved in liquidating the collateral (although this latter reason is, perhaps, with modern securities settlement systems less significant than it used to be).

In relation to highly creditworthy assets, such as U.S. government securities, the Valuation Percentage will typically be as high as 95 per cent. In commercial usage, one would say that a 5 per cent "haircut" had been applied to those U.S. government securities. In relation to less credit-worthy debt securities, a lower Valuation Percentage (or, in other words, higher haircut) would be applied.

It might seem odd to apply a Valuation Percentage to Cash, but typically this would only be done (if at all) in relation to currencies other than the Base Currency. In such circumstances, the Valuation Percentage primarily reflects potential volatility in the exchange rate between the other currency and the Base Currency.

<u>Note that the application of a Valuation Percentage or "haircut" is only relevant to calculation of variation margin obligations. The Valuation Percentage is not relevant to the determination of the Value of the Margin Received for purposes of the rights and remedies of a Taker (or, if the Taker is the defaulting party, the Provider) under Section 2.4, Section 3.2 or Section 4.1(b).</u> Of these provisions, only Section 3.2 uses the defined term "Value". To clarify this point, where parties have incorporated Part 3 of the Provisions into their Supplement, parties may wish to include in the Supplement an amendment to the definition of "Valuation Percentage" to add at the end of the definition the words ", except that, for purposes of Section 3.2, Valuation Percentage for purposes of valuing the Margin Received is 100%".

F. Margin Business Day

As is the case with the definition of "Local Business Day" in the ISDA Master Agreement, the definition of "Margin Business Day" in the Provisions varies according to context. In relation to a transfer of securities, a Margin Business Day is a business day for the relevant settlement system and in the location of the transferee's securities account.

In relation to transfers of Cash or property other than securities, a Margin Business Day is a business day in the place of the payee's account <u>and</u>, if different, in the principal financial centre "(if any)" of the relevant currency. The words "(if any)" were added to take into account, for example, the euro, which has no universally accepted principal financial centre.

In relation to valuations, a Margin Business Day is a business day in the location of the Calling Party and in any other place that the parties agree for this purpose. The Calling Party's location is chosen because the Calling Party is typically making the valuations and then calculations leading to the relevant margin call (for a delivery or return).

Finally, in relation to notices and other communications, a Margin Business Day is a business day in the place of location of the recipient of the notice. There are quite a few provisions of the Provisions under which a party is required to give notice in one form or another for various purposes. A number of these provisions provide specific rules for determining the time at which actions should occur. Careful attention should be paid by users of the Provisions to the interaction of the Margin Business Day definition with such provisions.

For example, under Section 1.6(c), which deals with dispute resolution in relation to the Value of a Transfer, the Calling Party issues a Notice of dispute on the Margin Business Day following the Margin Business Day the disputed Transfer was Initiated. Section 1.6(c)(i) provides that each reference in Section 1.6(c) to a Margin Business Day will be a reference to a Margin Business Day in the location of the Calling Party. Under the definition of "Margin Business Day", in relation to the Notice of dispute Margin Business Day would, as noted above, be a business day in the location of the recipient of the Notice, namely, the Call Recipient. The most sensible interpretation of this apparent conflict would be that the Notice of dispute should be delivered to the Call Recipient on a day that is a Margin Business Day in the location of the Calling Party (under Section 1.6(c)(i)) <u>and</u> in the location of the Call Recipient (under the definition of "Margin Business Day").

G. Eligible Margin, Equivalent Margin, Transfer Timing and Settlement Dates

1. Eligible Margin. In relation to each Valuation Date, if the calculations referred to above result in a party as Provider being required to transfer a Delivery Amount to the Taker, the Provider may transfer any margin assets that constitute <u>Eligible Margin</u>. Eligible Margin is any margin asset of a type specified in the Supplement. It is worth noting that the specific mechanism allowing parties to choose other forms of eligible margin such as guarantees, letters of credit, etc. (the concept of "Other Eligible Support" in the New York Annex) has not been reproduced in the Provisions. This is because it was felt that it was not used frequently enough by the market to warrant inclusion. The same effect could however be achieved relatively easily by adjusting the Threshold of a party to an amount equal to the letter of credit or guarantee.

A Provider may deliver other assets that do not constitute Eligible Margin, but as noted in Part II.E of this Guide such assets would be given a nil value for purposes of valuing the Margin Received. Delivery of such assets would therefore have no effect toward satisfying the Provider's margin delivery obligation.

Note that this could become relevant, even in the absence of a specific delivery by the Provider, where assets constituting Eligible Margin when provided are converted (for example, pursuant to a conversion or exchange clause in the terms of an issue of convertible or exchangeable securities) or mandatorily exchanged in connection with a nationalisation or freeze-out of minority shareholders. (These latter possibilities only relate to equity securities, which are less common as a form of Eligible Margin, at least in relation to an ISDA Master Agreement.)

Many ISDA members favour the use of Cash as Eligible Margin, commonly accepting U.S. dollars, euros, Japanese yen and pounds sterling, among others. The advantages of Cash include its ease and speed of delivery, reduced likelihood of substitutions (which involve risk) and potential reduction of related regulatory capital requirements in some jurisdictions. Certain other ISDA members would note that some counterparties may have problems holding or paying a market rate of interest on Cash margin and that the tax, accounting and/or regulatory capital treatment of Cash margin may be less favourable than for securities margin in some jurisdictions.

The parties must attempt to balance these concerns in reaching an agreement on the use of Cash margin.

2. Equivalent Margin. In relation to each Valuation Date, if the calculations referred to above result in a party as Taker being required to transfer a Return Amount to the Provider, the Taker must transfer to the Provider margin assets that constitute Equivalent Margin. The definition of "Equivalent Margin" varies according to which governing law and legal approach the parties have chosen:

(a) if the parties have chosen the security interest approach under New York law by incorporating Part 2 of the Provisions into their Supplement, then Equivalent Margin is the margin originally provided by the Provider; and

(b) if the parties have chosen the title transfer approach under English law by incorporating Part 3 of the Provisions into their Supplement, then Equivalent Margin consists of assets fungible with the initial margin provided.

The difference in these definitions reflects the fact that under (a) the Provider retains ownership of the original assets provided to the Taker, subject, of course, to the Taker's encumbrance and to the effect of any use of the margin by the Taker under Section 2.2(c). Under (b), the Provider has no continuing proprietary interest in the margin it originally provided. Its only entitlement in this regard is to the delivery of fungible assets equivalent to those it originally provided. This entitlement is conditional on its performing its obligations under the Agreement(s) collateralised by the Supplement.

In practice, of course, even under (a), the Taker may return fungible assets, particularly where it has used the original assets pursuant to Section 2.2(c).

3. Transfer Timing and Settlement Dates. As noted in Part I of this Guide, one of the most important objectives of the working group drafting the Provisions was to tighten the timing of transfers of margin to reduce settlement risk and bring those timings in line with related markets, such as the exchange-traded derivatives markets and the securities repo and stock lending markets.

Section 1.3 sets out the timeframes applicable to transfers of Delivery Amounts and Return Amounts under the Provisions. Section 1.3 is summarised in tabular form in Appendix C.

With one exception, each reference in Section 1.3 to a time or to a Margin Business Day is a reference to that time or Margin Business Day in the location of the Call Recipient, since it is the Call Recipient that must arrange for and Initiate the relevant Transfer. The exception is that any Transfer under Section 1.3 must be completed by 5:00 p.m. in the location of the account of the Calling Party.

As discussed above, the Calling Party will be the Taker if a Delivery Amount is due and the Provider if a Return Amount is due. If the Calling Party makes its margin call by the Notification Time (10:00 a.m. unless the parties specify otherwise) on any Margin Business Day, the Call Recipient must Initiate the Transfer of relevant margin assets by 5:00 p.m. on the same day. A margin call received after the Notification Time is deemed received at the Notification Time on the next Margin Business Day, unless a subsequent demand is sent, in which case the subsequent demand prevails.

The terms "Initiate" and "Transfer" are defined in the Provisions in order to make as precise as possible the obligations of the Call Recipient. The Call Recipient Initiates a Transfer by taking all steps necessary to achieve the Transfer by the Settlement Date, so that no further action by it is required. This approach was thought to be fairer to the Call Recipient, since its obligation is as far as possible dependent only on its own action and not subject to the potential vagaries of a third party or settlement system. The Call Recipient is obliged to notify the Calling Party once it has Initiated the Transfer so that, among other things, the Calling Party knows to investigate should the settlement fail to occur.

The meaning of "Transfer" varies, not surprisingly, according to the type of assets being transferred. In relation to Cash, "Transfer " means payment or delivery by wire transfer. In the unlikely event that certificated securities are used as margin, "Transfer" means physical delivery of the certificates together with relevant instruments of transfer, appropriately executed to give effect to the transfer, with any relevant transfer tax stamps and so on. In the normal case of fungible securities held and transferred in book-entry form, "Transfer" means Initiating the Transfer by the giving of written instructions (widely defined to include instructions by telephone, fax, telex, e-mail and other electronic systems) to the financial intermediary maintaining the relevant securities account of the Calling Party.

The Call Recipient's instructions Initiating its Transfer should provide for the relevant margin assets to be delivered by the Settlement Date. The definition of "Settlement Date" varies according to the type of margin assets involved. The Settlement Date for Cash in U.S. Dollars is the same Margin Business Day that the Transfer is Initiated. The Settlement Date for Cash in other currencies (and for property other than securities) is also the same Margin Business Day, unless that is not customary for the relevant currency (or other property), in which case the Settlement Date would be determined according to the customary settlement cycle for the relevant market. The Settlement Date for securities is determined in accordance with the customary settlement cycle for the relevant clearance system selected by the parties or, if none, for the market on which the securities are principally traded. In neither of these tests can be applied, the Settlement Date is the first date on which settlement can reasonably practicably be effected.

It is anticipated that for the majority of securities settlements, the parties will have agreed upon a specific clearance or settlement system. The trend of the past few years has been for securities settlement cycles to tighten, especially in the international settlement systems, and this is expected to continue, the defining limit, of course, being real-time settlement, as is now the case for many payments systems.

The Transfer must be completed by 5:00 p.m. on the relevant Settlement Date in the location of the account of the Calling Party. If not, the Calling Party may give one of two types of Notice:

(1) it may simply notify the other party of the failure and request remedy by a certain time and day; or

(2) it may give a Notice declaring an Event of Default.

The giving of the former Notice does not prejudice the ability of the Calling Party to give the latter Notice subsequently if the failure is not remedied.

If the Call Recipient fails to give the Notice (mentioned above) that a Transfer has been Initiated, the Calling Party has the same right to give the notice in (1) or (2) above.

Note that careful attention should be paid to the transfer timings required by the Provisions when the Provider, the Taker and/or relevant margin assets are in widely separated time zones. In such circumstances, the parties may, for practical or administrative reasons, need to make appropriate amendments in the Supplement to the timings provided for in Section 1.3.

Examples:

(1) Bank A is a Japanese multibranch bank headquartered in Tokyo. It has entered into a Supplement incorporating the Provisions under which the only Eligible Margin is U.S. Treasuries. Bank A's collateral management unit is located at its head office in Tokyo. The administrative function responsible for settlement of U.S. Treasuries is located at its New York branch. Bank A's collateral management unit in Tokyo is not in a position to know the composition and balances of its holdings of U.S. Treasuries on a real-time basis. Bank A, as Call Recipient, receives a demand for transfer of Eligible Margin, by the Notification Time, which by virtue of Section 1.3 (a) is 10:00 a.m., Tokyo time. As a practical matter, however, it cannot Initiate Transfer of the Eligible Margin by 5:00 p.m., Tokyo time on that same Margin Business Day, since it is not able by that time to confirm with its operations staff in New York the relevant details of the U.S. Treasuries it intends to transfer.

When the New York branch of Bank A opens, several hours after the Tokyo collateral management unit has closed, the New York operations staff are able to respond to the request for information on U.S. Treasury holdings available for transfer as margin. The following Margin Business Day in Tokyo, the head office collateral management unit makes its decision on the margin assets to be transferred and relays those internally to New York for action when the New York branch opens. So the relevant transfer is Initiated after the close of business in Tokyo during the day in New York. Bank B is not able to provide the Notice required by Section 1.3(b) until the next Margin Business Day in Tokyo, which is the second Margin Business Day after receipt of the margin call.

(2) Bank B is a U.S. multibranch bank headquartered in New York City, with a branch in Tokyo. It has entered into a Supplement incorporating the Provisions under which Eligible Margin includes Japanese Government Bonds ("JGBs"). On a Valuation Date on which as Taker it is holding JGBs as Margin Received, Bank B receives a demand from the Provider for a Return Amount. The Notice from the Provider demanding Transfer of Equivalent Margin in respect of that Return Amount specifies JGBs. Bank B is not able to confirm the necessary details with operations personnel in Tokyo regarding the JGBs to be delivered to the Taker and is therefore not able to Initiate Transfer until the next day on which banks are open for business in both Tokyo and New York.

While the parties are, of course, free to amend or supplement any provision of the Provisions, including the transfer timing provisions of Section 1.3, they should do so with great care. Any modifications in relation to transfer timing (for example, changing the Notification Time) may necessitate corresponding changes elsewhere in the Provisions, particularly in relation to the dispute resolution procedures.

If parties are making daily demands for margin, the provisions of Section 1.3 may result in two calls being received by the Call Recipient on the same day. For example, if the Calling Party makes a demand for margin after the Notification Time, it will be deemed received at the Notification Time on the next Margin Business Day. If, however, on the morning of the next Margin Business Day, the Calling Party transmits a second demand before the Notification Time, the second demand will be deemed to supersede the first one.

H. Conditions Precedent

Section 1.2 of the Provisions sets out conditions precedent to the obligations of each party under the Provisions. These conditions, which are comparable to those set out in Section 2(a)(iii) of the ISDA Master Agreement, ensure that a party does not have to deliver margin to a party that is about to default, has already defaulted or has had all of its obligations under a related Agreement accelerated.

It is also a condition precedent that no Specified Condition has occurred with respect to the other party. The parties may specify Specified Condition in the Supplement. Typically, the parties would specify one or more Termination Events under the ISDA Master Agreement or comparable events in non-ISDA Agreements.

I. Additional Events of Default

Section 1.4 of the Provisions provides that, in addition to the Events of Default set out in the relevant Agreement(s) collateralised by a Supplement incorporating the Provisions, the following will constitute Events of Default:

(1) a failure to make a payment or delivery or to perform any other obligation arising under the Provisions; and

(2) after a margin call, failure to give Notice under Section 1.3(b) that a Transfer has been Initiated.

There is a cure period of one Margin Business Day after Notice for any failure to pay, deliver or give a Notice under Section 1.3(b). There is a cure period of thirty calendar days after Notice for any other breach of an obligation under the Provisions. There is also a carve-out in Section 1.4 where a failure to make a payment or delivery is related to a dispute, as long as the dispute is being dealt with under the dispute resolution procedures of Section 1.6.

J. Procedures for Dispute Resolution

1. Overview. As noted in Part I of this Guide, one of the key objectives of the ISDA working group drafting the Provisions was to tighten the timing of and improve the procedures for dealing with dispute resolution, with a view, among other things, to reducing the ability of a party using the dispute resolution procedure as a pure delaying tactic. The dispute resolution procedures are set out in Section 1.6 of the Provisions and are summarised in tabular form in Appendices D.1 and D.2.

The new procedures define the responsibility of each party to provide information to the other in the event of a dispute, the nature of the information to be provided, the timeframes within which the relevant information is to be provided and the action each party must take in relation to that information. The procedure differs depending upon the nature of the dispute. One procedure applies to disputes of a Delivery Amount or Return Amount. The other applies to disputes relating to the Value of a transfer of margin.

Like the transfer provisions, the timeframe for dispute resolution has been compressed. The key location in the dispute resolution timing mechanism for dispute of Delivery Amounts or Return Amounts is the location of the Disputing Party. The key location in the timing mechanism for disputes of the Value of a transfer is the location where the margin was delivered.

2. Dispute of Delivery Amount or Return Amount. In relation to disputes concerning a Delivery Amount or Return Amount, the following procedure applies:

When a Call Recipient disputes a demand for either a Delivery Amount or a Return Amount it must (a) transmit a Notice of dispute by 1:00 p.m. on the same Margin Business Day, (b) Initiate Transfer of any Undisputed Amount and (c) transmit Portfolio Information in an electronic format for receipt by the Calling Party by 5:00 p.m. that day. The Call Recipient becomes, then, the Disputing Party.

An Undisputed Amount is, in effect, the lesser of the two amounts that the parties allege should be Transferred in relation to a specific margin call.

> *Example*: A Calling Party demands a Delivery Amount of USD 11,000 and the Call Recipient alleges that the correct Delivery Amount is USD 8,000 (in each case, after rounding and assuming that the Minimum Transfer Amount is less than USD 8,000). In such circumstances, the Undisputed Amount is USD 8,000.

There will be situations where the Undisputed Amount is zero. For example, where the parties do not agree as to which party has an Exposure on the relevant Valuation Date or where the lesser of the two amounts determined by the parties is below the Minimum Transfer Amount. In the example above, if the Minimum Transfer Amount were USD 10,000, the Undisputed Amount would be zero.

It is then up to the Calling Party to review the Portfolio Information and all other relevant information and revert to the Disputing Party with the results of its review by 10:00 a.m. the next Margin Business Day (the "Second Day"). This will take the form of a notice which must address the issues set out in Section 1.6(b)(iii).

By 1:00 p.m. on the Second Day, the Disputing Party must acknowledge the accuracy of the Calling Party's review or specifically challenge any items in it. If the Disputing Party challenges the review, both parties must attempt to negotiate a resolution by 5:00 p.m. on the Second Day. Any failure to comply with the request for information delivery during this process will be treated as agreement with the other party with respect to the dispute.

If the dispute relates to Exposure or Value of Margin Received and if it has not been resolved by 5:00 p.m. on the Second Day, then each party must select an independent reference source to determine the Exposure or Value of Margin Received, as the case may be. The independent reference sources must reply by 5:00 p.m. on the next Margin Business Day (that is, the third Margin Business Day). If this procedure fails for any of the reasons set out in the Provisions, the parties should seek to resolve the dispute by other procedures.

3. Dispute of Value of Transfer. If a Calling Party disputes the Value of a Transfer of Eligible Margin, Lock-up Margin, Substitute Margin or Equivalent Margin, it must, as Disputing Party, send a Notice of dispute to the other party for receipt by 1:00 p.m. on the Margin Business Day following the Margin Business Day on which the Transfer was Initiated.

Before 10:00 a.m. on the Margin Business Day following receipt of the Notice of dispute, the Call Recipient must recalculate the Value of the relevant margin using any undisputed values referred to in the Notice of dispute. Immediately following its recalculation, the Call Recipient must report the results to the Disputing Party. The Call Recipient must Initiate any additional Transfer of Eligible Margin or Equivalent Margin required based on the recalculation by 5:00 p.m. on that same Margin Business Day.

If the Call Recipient is unable to recalculate the Value of the relevant margin or the Disputing Party disputes the recalculated Value of the relevant margin, the Parties have three alternatives:

(1) continue the negotiations;

(2) seek such other remedy as each in its discretion determines; or

(3) if "Dispute Termination Event" is specified as applicable in the Supplement, terminate the Transaction(s) in relation to which the dispute arose.[24]

The dispute resolution process, like any other timed procedure for communication between parties, presents the risk of technical or accidental noncompliance. While granting that possibility, ISDA members believe that it is best that the document require strict compliance, with any variations from strict compliance to be agreed between the parties on a case by case basis. This strict compliance is maintained in Section 1.6 (a)(ii) by the provisions declaring that a failure to comply constitutes deemed agreement to the other party's position in the dispute.

K. Substitutions

Section 1.7 deals with substitutions of margin. Appendix E summarises these provisions in tabular form. As noted in Part I of the Guide, tightening the timing of and improving the procedure for substitutions was another goal of the working group that prepared the Provisions.

Each reference in Section 1.7 to a time or Margin Business Day is a reference to that time or Margin Business Day <u>in the location of the Taker</u>.

If a Provider wishes to substitute margin previously provided to a Taker, it should deliver a Substitution Notice to the Taker by 5:00 p.m. on the day it wishes to Initiate Transfer of the Substitute Margin. If the Notice is received by the Taker after 5:00 p.m., it is deemed to be received on the next Margin Business Day.

The parties may provide in Paragraph 8 of the Supplement that the Taker must consent to any substitution of margin. This might be advisable, for example, in relation to a Provider organised as a company in England, if the parties have elected the New York law security interest approach in their Supplement, in order to minimise the risk of the Supplement being characterised as a floating charge, as opposed to a fixed charge, as a matter of English law. Although the governing law in such a case would be New York law, the security interest created by the Supplement would still require characterisation as a matter of English law for certain purposes, including the provisions of the UK Companies Act 1985 relating to registration of charges. Also, a floating charge would have a lower ranking on the eventual insolvency in England of the Provider than would a fixed charge. Note that this concern does not arise if the English title transfer approach is elected in relation to the Provider as that approach does not involve creation of a security interest, and therefore there is no need to characterise it as fixed or floating.

24 Section 1.6(c)(v)(B) provides that the Dispute Termination Event, if applicable, operates "to terminate the Agreement". Under the ISDA Master Agreement, of course, a Termination Event operates to terminate not the Agreement itself but Transactions, either all Transactions or only Affected Transactions, depending on the nature of the event. Accordingly, if the relevant Agreement is an ISDA Master Agreement, a Dispute Termination Event, if invoked pursuant to Section 1.6(c)(v)(B) of the Provisions, should be interpreted as terminating all Transactions.

The Provider must Initiate Transfer of the Substitute Margin by 1:00 p.m. on or after the Margin Business Day on which the Substitution Notice is effective. Clearly, if the Provider wishes to Initiate the Transfer on the same Margin Business Day that the Substitution Notice is effective, it should obtain any consent required from the Taker by 1:00 p.m. on that same Margin Business Day.

If the Taker has confirmed receipt of the Substitute Margin by 1:00 p.m. on a Margin Business Day, then it must Initiate Transfer of Equivalent Margin specified by the Provider in its Substitution Notice by 5:00 p.m. on the same Margin Business Day. If receipt is confirmed after 1:00 p.m., then the Taker must Initiate Transfer of Equivalent Margin by 5:00 p.m. on the next Margin Business Day. The Equivalent Margin must be of a Value on the day Transfer is Initiated as close as practicable to, but not greater than, the Value of the Substitute Margin.

Assuming that the timeframe outlined above is followed, the shortest possible time within which a full substitution cycle could complete would be the same Margin Business Day on which the Substitution Notice is given.

> *Example*: The Provider gives a Substitution Notice at about 9:00 a.m. on a Margin Business Day. Notice is given by an electronic messaging system, so it is received by the Taker moments after it is sent. No consent of the Taker to the substitution is required. The Provider Initiates Transfer of the relevant Substitute Margin immediately thereafter. The Substitute Margin is Cash in U.S. Dollars, so the Settlement Date is the same Margin Business Day. The Taker confirms receipt of the U.S. Dollars by 9:30 a.m. on that day and so immediately Initiates Transfer of Equivalent Margin with a Settlement Date also of the same Margin Business Day.

Generally speaking, the Provisions attempt to recognise that although substitutions may increase risk in the collateralisation process, they are a common commercial occurrence that must be dealt with quickly and efficiently.

L. Distributions and Interest Amount

Section 1.8 provides, in relation to securities provided as margin, that the economic benefit of Distributions (income and other rights accruing to holders of those securities) will be passed back to the Provider. Section 1.8 also provides for Interest Amounts to be paid on Cash margin. Note that for purposes of Section 1.8 Margin Received includes Lock-up Margin.

Under Section 1.8(b), on the Margin Business Day immediately following a Distributions Date (the day on which holders of the securities are entitled to receive the relevant Distribution) the Taker must Initiate Transfer of Equivalent Distributions to the Provider. Equivalent Distributions are assets fungible with the Distributions received by holders of the relevant securities.

A Taker is only required to Transfer Equivalent Distributions to the extent that a Delivery Amount would not be created or increased by the Transfer. Any Equivalent Distributions not Transferred as a result of this condition are included in the Margin Received.

Note that it is irrelevant for purposes of Section 1.8(b) whether the Taker actually received the Distributions itself. It may, for example, have sold the relevant securities prior to the Distributions Date, either pursuant to its right of use under Section 2.2(c), if Part 2 of the Provisions applies, or as owner of the relevant securities, if Part 3 of the Provisions applies.

Under Section 1.8(c), Interest Amounts are payable by the Taker in relation to Cash margin at the relevant Interest Rate specified in the Supplement for the currency of that Cash margin and on the other terms specified in the Supplement. The assumption in the suggested form of Supplement in Appendix A to the Provisions is that interest will be paid on a simple, rather than a compounding, basis, but parties are, of course, free to vary this if they wish.

Interest accrues on each day of each relevant Interest Period. "Interest Period" means each period from (and including) the date on which an Interest Amount was last transferred to the Provider (or, if none, the date on which the relevant Cash margin was first received by the Taker) to (but excluding) the next period end date. The form of Supplement in Appendix A to the Provisions suggests two possibilities for period end dates, namely, (a) the first calendar day of each month and (b) any date on which a Return Amount consisting wholly or partly of Cash is Transferred to the Provider under Section 1.1(b). Parties could use one or both of these as period end dates and/or specify additional period end dates in the Supplement.

The Interest Amount is the sum of the amounts of interest determined for each amount of Cash margin in each currency and for each day during the relevant Interest Period, multiplied by the relevant Interest Rate and divided by 360 (or, if the currency is pounds sterling, 365).

Transfer of an Interest Amount must be Initiated no later than two Margin Business Days after the end of the relevant Interest Period, provided that a Taker is not obliged to pay an Interest Amount on any Margin Business Day if, after so doing, the Taker would be owed a Delivery Amount or the Delivery Amount it would otherwise be owed would be increased. Any Interest Amount accrued but not paid forms part of the Margin Received.

Finally, note that an Interest Amount accrues only for the period from the last date an Interest Amount is paid to (but excluding) the next period end date. Payment of the Interest Amount is due on the second Margin Business Day after the Interest Period. Therefore, no interest accrues for the period from (and including) the relevant period end date to (and excluding) the Margin Business Day on which the Interest Amount is transferred. This would therefore normally be a period of at least two calendar days and could be longer if non-business days intervene.

M. Additional Definitions with Respect to Margin Subject to Article 8 of the New York Uniform Commercial Code

Although Part 1 of the Provisions is concerned primarily with economic and commercial, rather than legal, terms, Section 1.9 clarifies that Article 8 of the New York Uniform Commercial Code ("NYUCC") will apply to any Margin Received or Equivalent Margin of a type that would otherwise fall within Article 8.

Article 8 of the NYUCC will generally apply to securities held as margin by the Taker in an account in the State of New York, regardless of which governing law and legal approach has been chosen. Article 8 of the NYUCC does not apply to Cash margin.

Section 1.9 of the Provisions was included to enhance legal certainty in relation to the treatment of securities margin held in New York and was included in Part 1, rather than Part 2, since it is intended to apply regardless of whether Parts 2 or 3 and/or Section 4.1 is elected. Also, this provision was not included as an additional Section in Part 4 of the Provisions as the provisions of Part 4 are meant to be elective, whereas this Section 1.9 is not. (Of course, the parties could specifically disapply it in the Supplement if they so wished.)

Although the question may arise why similar provisions were not included in relation to margin held in jurisdictions other than New York, U.S. Dollar Cash and U.S. Dollar denominated securities held in New York represent a considerable portion of the total global holdings of margin for privately negotiated derivatives and similar transactions. A specific provision dealing with New York based margin was therefore considered justified.

N. Miscellaneous

Section 1.10 includes miscellaneous provisions dealing with: expenses of Transfers (each party bears its own); default interest (payable at the Default Rate on the basis of daily compounding and the actual number of days elapsed); demands and notices; specifications of certain matters (basically, that anything that the Provisions say should be specified in the Supplement may be specified in a Confirmation or other document, if the parties so agree); and the general obligation of the parties to act in good faith and in a commercially reasonable manner in making any calculations, valuations or determinations.

The Provisions include various forms of Notice in various Appendices, which may but need not be used. Of course, most parties will find it convenient to use the suggested forms. If they do not, they will need to take particular care to ensure they have included all relevant information required in the Notice. Minor deviations, however, from the suggested forms of Notice will not cause a problem if, judged as a whole, all the required information is clearly set out.

The forms of Notice in the Appendices include:

(1) a Notice under Section 1.3 that Transfer has been Initiated and the relevant Settlement Date (Appendix B);

(2) a Notice under Section 1.3(e) of failure to make a Transfer or give the Notice required by Section 1.3(b) (Appendix C);

(3) a Notice under Section 1.4(b) that an Event of Default has occurred under the Provisions (Appendix D);

(4) a Notice of Dispute under Section 1.6(b) (Appendix E);

(5) a Notice of Dispute under Section 1.6(c) (Appendix F); and

(6) a Substitution Notice under Section 1.7 (Appendix G).

All notices made pursuant to the Provisions are to be made in accordance with the Notices Section of the Provisions, which in turn refers to the Notices provision of the relevant Agreement(s) to which the Supplement relates (Section 12 in relation to the ISDA Master Agreement).

III. ELECTION OF LEGAL APPROACH

A. Overview

As discussed above, the Provisions contemplate that parties will have a choice of governing law and legal approaches to the creation of a margin arrangement using the Provisions.

The New York law security interest approach set out in Part 2 of the Provisions is essentially the same as that used in the New York Annex. The User's Guide to the 1994 ISDA Credit Support Annex provides helpful background on this approach.

The English law title transfer approach set out in Part 3 of the Provisions is largely the same as that used in the English Annex. The User's Guide to the ISDA Credit Support Documents provides helpful background on the title transfer approach, including a comparative discussion contrasting the title transfer approach with the security interest approach under the New York Annex. There are a couple of structural changes in the way in which the title transfer approach is implemented in the Supplement incorporating the Provisions. Some ISDA members during the drafting of the Provisions raised concerns about these changes and the possible impact of those changes on the insolvency law analysis of this approach in certain jurisdictions. These issues are discussed below.

The Japanese law loan collateral approach set in Section 4.1 of the Provisions is essentially the same as the loan collateral provisions used in the Japanese Annex. The User's Guide to the 1995 ISDA Credit Support Annex (Japanese Law) provides helpful background on this approach.

B. Elective Provisions: Security Interest Approach (New York Law)

The security interest approach set out in Part 2 of the Provisions is substantially the same as the approach taken in the New York Annex.

1. Security Interest and Set-off. Each party, as Provider, pledges and creates a first priority continuing security interest in, lien on and right of set-off against all Margin Received Transferred to the Taker in the form of Eligible Margin (or other property falling within the definition of "Margin Received"). This broad (apparently repetitive) formulation of the creation of a security interest in favour of the Taker is customary in New York law security documents of this type and is intended to ensure, as far as possible, that the Taker has an effective interest, regardless of the nature of the Margin Received.

Section 2.1, as is also customary in New York law security documents in relation to securities and Cash, includes a right of set-off against the Margin Received. There are two points to note here. First, a right of set-off is not itself a proprietary interest by way of security. Secondly, a party may only exercise a right of set-off against a debt claim that it owes, not against a property claim. The coupling of a security interest and right of set-off in Section 2.1 is to reflect the fact that the Margin Received may represent different types of interests from the point of view of the Provider, including proprietary claims to securities held as margin by the Taker (and not disposed of by the Taker under its right of use in Section 2.2(c)) and debt claims against the Taker (for example, in relation to accrued Interest Amounts).

Note that the security interest created by Section 2.1 only relates to Eligible Margin actually received by the Taker. It does not cover "in-flight securities", that is, securities in respect of which Transfer has been Initiated by the Provider but not yet received by the Taker.

The security interest created by Section 2.1 is automatically released, without further action by either party, in relation to any margin included within a Return Amount.

2. Holding and Using Margin Received. The various provisions of Section 2.2 reflect the fact that the Taker has only a partial interest in the Margin Received and that, subject to certain conditions, the Provider has a continuing proprietary interest in some or all of those assets.

a. Care of Margin Received. Margin Received and held by the Taker belongs to the Provider, subject, of course, to the security interest of the Taker. The Provisions (and New York law) impose a duty of reasonable care of the Margin Received on the Taker. It must keep the relevant assets in safe custody and must exercise "at least the same degree of care as it would exercise with respect to its own property". Beyond that, though, the Taker has no duties in relation to the Margin Received, for example, to exercise voting rights, enforce or preserve any rights of a holder of securities against the issuer of those securities or to collect Distributions. Note that in relation to that last example that under Section 1.8 the Taker is obliged to pay Equivalent Distributions to the Provider regardless of whether or not it actually collects Distributions in relation to those securities. Note also that the Taker's duty of care in relation to the Margin Received is without prejudice to its right to use the Margin Received, if any, under Section 2.2(c).

b. Eligibility to Hold Margin Received; Custodians. Another consequence of the limited nature of the Taker's interest in the Margin Received is the fact that the Provider may impose conditions on the Taker's ability to hold the Margin Received or the ability of a Custodian appointed by the Taker to hold the Margin Received. Any such conditions should be set out in the Supplement. If a Taker or its Custodian fails to satisfy any such condition, the Provider may demand the Transfer of all Margin Received to a Custodian that does satisfy the relevant conditions. If no such Custodian is specified, then the Margin Received must be Transferred to (or, as the case may be, remain with) the Taker. The Taker accepts liability for any act or omission of its Custodian. Examples of the types of condition that the parties may wish to specify for this purpose are discussed in Part IV below in relation to Paragraph 14 of the Supplement.

c. Use of Margin Received. One of the most commercially useful aspects of a New York law pledge over securities is the fact that the pledgee may, with the express consent of the pledgor, use the pledged assets. As discussed in Part I, the title transfer approach was developed in the UK and in other European markets primarily because under the laws of virtually all European countries it is not possible for a pledgee under a traditional pledge to be permitted to use the pledged assets, at least not without endangering the pledge security interest. The basic problem is that a free right to dispose of an asset is not compatible with the partial nature of the pledgee's interest.[25]

Under Section 2.2(c) of the Provisions, unless otherwise provided in the Supplement and provided that certain conditions are satisfied (essentially that the Taker

25 A number of European countries (for example, Italy, as discussed in footnote 3 above), have a concept of "irregular pledge" under which use of the pledged assets by the pledgee is permitted. An irregular pledge, however, generally appears to be in substance a title transfer arrangement, although it may retain some of the characteristics of a pledge.

has not defaulted), then, notwithstanding Section 9-207 of the NYUCC, the Taker will be permitted to use the Margin Received in a variety of ways specified in Section 2.2(c)(A) and (B). Essentially, these cover all the likely possible uses the Taker might wish to make of the assets, including outright disposition. Any such disposition would be free and clear of any equity or right of redemption or any other continuing interest of the Provider in the relevant assets. The Taker may also have assets comprised in the Margin Received registered in its own name, the name of its Custodian or the name of a nominee for either.

Note that the term "rehypothecation", widely used in the market (especially by non-lawyers) to mean any use of collateral by a secured party, strictly speaking means only re-pledging. To avoid confusion on this score (for example, when discussing this provision with local counsel in other jurisdictions), the term "rehypothecation" is best avoided or, if used, limited clearly by context to its correct technical meaning.

The right of use in Section 2.2(c) will be deemed to apply if the parties do not specify otherwise in the Supplement. As noted above, notwithstanding any disposition of margin securities received from a Provider, the Taker will be deemed to receive any Distributions arising on those securities for purposes of Section 1.8. The Taker is also deemed to continue to hold all such margin securities for purposes of the provisions of Sections 1.1, 1.3, 1.6 and 1.7 of the Provisions.

Parties should carefully consider the risks entailed by permitting the Taker to dispose freely of Margin Received by way of sale, repo, re-pledge or other disposition and may wish to consult with their legal advisers on this point. In particular, parties should consider whether the inclusion of consent to such use would affect the characterisation of the Provisions in any jurisdiction where the Provider is incorporated or located or where relevant margin assets are located.

Parties may, if they wish, permit a Taker to use Margin Received, but only subject to conditions or restrictions specified in the Supplement. Paragraph 15 of the form of Supplement in Appendix A to the Provisions includes a place for setting out any such condition or restriction.

3. Additional Event of Default. Section 2.3 provides for an additional Event of Default if a party fails to respect a prohibition on use of Margin Received under Section 2.2(c) or fails to observe any condition or restriction placed on its right as Taker to use Margin Received under Section 2.2(c). The Event of Default is subject to a cure period of five Margin Business Days after Notice of such a failure to the relevant party.

4. Certain Rights and Remedies. Section 2.4 is the key provision for giving effect to the intended credit protection of the New York law security interest approach. It sets out certain rights and remedies of the Taker against the Provider, as well as rights *in rem* of the Taker against the Margin Received, and preserves any other rights and remedies that the Taker may have as a secured party as a matter of general law. It reiterates the Taker's right to set off any amounts payable by the Provider in respect of Obligations against any debt claims the Taker owes to the Provider in relation to Margin Received.

Section 2.4(b) sets out the acknowledgement of the parties that Margin Received in the form of securities may decline rapidly in value, by implication due to market fluctuations. Accordingly, securities of a type customarily sold on a recognised market may be sold, in the event of enforcement under Section 2.4, without Notice to the Provider (to the extent such Notice can be waived under applicable law). Apart from the Notice issue, Section 2.4(b) may be helpful in persuading a bankruptcy court or relevant insolvency official to permit a sale of securities held as margin notwithstanding the imposition of a bankruptcy freeze or stay in relation to the Provider. The argument would be that it is in the interest of the other creditors of the Provider that the maximum possible value be obtained for securities margin held by the Taker. It is therefore a sensible decision to insulate the Margin Received (and therefore the Taker's claim against the Provider in relation to the Obligations) from further market risk by permitting the Taker to sell the margin securities before the end of the relevant freeze or stay.

Recognising that a Taker may be the defaulting party, Section 2.4(c) sets out the rights and remedies of the Provider in the event of the Taker's default and acceleration of its Obligations under the related Agreement(s). Essentially, the Taker is obliged to return Margin Received (including Lock-up Margin) to the Provider, and the Provider is able to exercise a right of set-off between its Obligations and the Cash equivalent of the Margin Received. The effect of this provision, in other words, is, at the election of the Provider, to turn any proprietary claim that the Provider may have had to specific margin assets in the hands of the Taker into a debt claim owed by the Taker, thereby rendering it amenable to set-off. As an additional protection, the Provider may withhold payment of any Obligations to the extent that it does not exercise its right of set-off and to the extent of any Margin Received not yet Transferred by the Taker to the Provider.

Sections 2.4(d) and (e) set out standard "boilerplate" provisions dealing with deficiencies, excess proceeds and final returns. Essentially these provide that, after enforcement under Section 2.4: (i) if the Obligations are not fully discharged, the Provider remains liable for any deficiency; (ii) if there are proceeds of the realisation of Margin Received remaining after application against the Obligations, those proceeds are to be handed over to the Provider; and (iii) if, at any point, the Provider has no present or future, absolute or contingent, Obligations to the Taker, then any Margin Received then held by the Taker must be returned to the Provider.

5. Representations. Section 2.5 sets out representations to be made by each party as a potential Provider (and deemed repeated on the date of each Transfer of margin to the other party as Taker) to the effect that: (a) it has the necessary power to grant the security interest and other rights created by Part 2 of the Provisions; (b) it is the sole owner of margin Transferred, free and clear of any third party interest; (c) the security interest created under Section 2.1 is a "valid and perfected first priority security interest"; and (d) the performance by it of its obligations under the Provisions will not result in the creation of any security interest or other encumbrance in favour of any third party in the Margin Received (for example, as a result of a negative pledge granted by the Provider).

These representations are essentially the same as those set out in Paragraph 9 of the New York Annex. They are standard representations in a New York law security document.

6. Distributions. Section 2.6 clarifies that a Taker will be deemed to have received Distributions for purposes of its obligation to Transfer Equivalent Distributions to the Provider under Section 1.8 in relation to any securities comprised in the Margin Received. This is notwithstanding the fact that it has no duty to collect such Distributions under Section 2.2(a) and the fact that it may not actually be holding the relevant securities as a result of its right of use under Section 2.2(c).

7. Expenses. Section 2.7 clarifies that the Provider bears all taxes or similar charges in relation to Margin Received, except in relation to any portion of the Margin Received disposed of or otherwise used by the Taker under Section 2.2(c). It also provides that expenses of enforcement under Section 2.4 will be borne by the relevant defaulting party, whether it is the

Provider or the Taker. If close-out occurs as a result of a no-fault event, each party bears its own expenses.

8. Miscellaneous. Section 2.8 includes standard "boilerplate" provisions relating to "further assurances" and "further protection". Section 2.8(a) provides essentially that each party will co-operate with the other party in satisfying any formalities (for example, in connection with any relevant perfection requirements) necessary to enable the other party to enforce the margin arrangement or, where appropriate, to release any assets from the effect of the margin arrangement. Section 2.8(b) provides that the Provider will promptly give the Taker Notice of any proceedings brought against or potentially affecting Margin Received, unless any such proceeding results from the Taker's exercise of its right of use under Section 2.2(c).

C. Elective Provisions: Title Transfer Approach (English Law)

The title transfer approach set out in Part 3 of the Provisions is substantially the same as the approach taken in the English Annex.

When used with the ISDA Master Agreement, the approach relies on the netting provisions of the ISDA Master Agreement for its effectiveness. Unlike the English Annex, however, Part 3 of the Provisions does not rely on a characterisation of the Supplement itself as a Transaction for purposes of the ISDA Master Agreement. The characterisation of the English Annex as a Transaction has the effect, among other things, of bringing obligations under the English Annex within the scope of Section 2(a)(i) of the ISDA Master Agreement. As a drafting matter, this automatically brings the English Annex within the scope of the conditions precedent in Section 2(a)(iii), the default interest provision of Section 2(e), the Failure to Pay Event of Default in Section 5(a)(i) and the early termination and close-out netting provisions of Section 6, especially Section 6(c)(ii) and Section 6(e), without the need for additional drafting to that effect.

As a matter of drafting, these aims could have been achieved in other ways, but perhaps less conveniently. The characterisation of the English Annex as a Transaction for purposes of the ISDA Master Agreement is not, as a matter of English law, fundamental to the effectiveness of the margin arrangement created under it. In other words, the same result could have been achieved without characterising the English Annex as a Transaction. Local counsel in other jurisdictions, however, may have considered this structural aspect of the English Annex to be relevant for purposes of their own insolvency law analysis when preparing their opinions for ISDA or ISDA members on the Credit Support Documents. A review of the collateral opinions obtained by ISDA does not suggest that this is the case, but the importance of this point should be checked by a party's legal advisers when considering the enforceability of the English Annex against the other party in the event of its insolvency in its jurisdiction of organisation (or other relevant jurisdiction).

Where the title transfer approach set out in Part 3 of the Provisions is used with one or more non-ISDA Agreements, it relies on contractual set-off. This ensures that the approach may apply broadly and flexibly to Agreements drafted in a variety of ways.

1. Transfer of Title and No Security Interest. Section 3.1(a) of the Provisions provides that each Transfer under the Provisions is intended to be a Transfer of full ownership in the relevant assets from the transferor to the transferee, free and clear of any continuing interest of the transferor or of any third party. In relation to Cash, note that "Transfer", as defined in Section 5.45 of the Provisions, simply means payment. In other words, one should not think of Transfers of Cash under the Provisions as being a transfer of a proprietary interest in an identifiable fund of money (like a transfer of an interest in a trust fund), if that would be analysed differently from a payment.

Section 3.1(b) clarifies the intention of the parties not to create a security interest in assets transferred, since that would defeat one of the principal commercial purposes of the title transfer approach. The title transfer approach was developed by the derivatives market (and in the related securities lending and repo markets) in order to permit a transferee of collateral to use the collateral received (for example, for purposes of re-sale, on-lending, repo or re-pledge), without the restrictions normally applicable to a pledgee's use of collateral under a pledge. Because the legal basis of arrangement is outright transfer, the transferor has no continuing interest in the assets transferred and is therefore an unsecured creditor of the transferee for the value of the collateral transferred should the transferee itself become insolvent before equivalent collateral has been returned to the transferor.

This material difference in the substantive analysis of a title transfer arrangement relative to a pledge is one of the principal reasons why, as a matter of English law (and in a number of other jurisdictions), a properly drafted title transfer arrangement is generally considered not to be subject to a significant degree of recharacterisation risk. Of course, the parties must ensure that they conduct their margined trading relationship in a manner consistent with the intention expressed in Section 3.1(b). Recharacterisation risk might arise, for example, if there were a side agreement between the parties (written or oral, formal or informal) that the transferee does not have a free right to use the assets transferred, is required to hold those assets in a segregated account and must return the <u>same</u> assets once the obligations of the transferor are discharged.

It is crucial to the effectiveness of the title transfer approach that the Provider never be entitled to the return of the same assets that it provided but only to fungible equivalent assets and, in the case of a default and subsequent acceleration of Obligations, only to payment of the Value of those assets at that time.

Note that there is a carve-out in Section 3.1(a), in relation to third-party interests, for liens routinely imposed on all securities in a relevant clearance system.

2. Default. Section 3.2 is the key provision for giving effect to the intended credit protection of the title transfer approach. It provides that if all obligations under an Agreement collateralised by a Supplement incorporating the Provisions are accelerated on a Close-out Date (for example, an Early Termination Date under an ISDA Master Agreement) as a result of an Event of Default or Specified Condition, then:

(1) if the related Agreement is an ISDA Master Agreement, the Value of the Margin Received will be taken into account as an amount due from the Taker for purposes of the calculations due under Section 6(e); and

(2) in the case of any other type of Agreement, the non-defaulting party will be entitled to exercise a right of set-off between Obligations due from the Provider and the Value of Margin Received.

In relation to (2), the "direction" of the set-off depends on whether the non-defaulting party is the Provider or the Taker in relation to the relevant Margin Received.

Note that for the purposes of Section 3.2, Margin Received includes Lock-up Margin as well as any Distributions and Interest Amounts accrued but not yet delivered or paid to the Provider. In addition, when determining the Value of Margin Received for purposes of Section 3.2, the Valuation Percentage should be 100%.[26]

If there is any excess Value of Margin Received after the application of Section 3.2(a), the Taker is required to Transfer Equivalent Margin in the amount of such excess to the Provider. This obligation, however, may be subject to other rights of set-off that the Taker may enjoy against the Provider, for example, under a broad contractual set-off in the related Agreement, under an insolvency set-off provision or on some other basis, such as an independent (judicial) set-off or a transactional (equitable) set-off.

Clearly, if the Value of the Margin Received is insufficient to discharge all of the Obligations of the Provider, the Provider remains liable to the Taker for the unpaid Obligations.

Note that it follows from the nature of the title transfer approach created by Part 3 of the Provisions that the concept of Margin Received should not be thought of in the same manner as Margin Received under the security interest approach in Part 2 of the Provisions. Under the provisions in Part 3, the Provider has no continuing proprietary interests in the Eligible Margin (and other property) comprised in the Margin Received. The Margin Received simply represents a conditional contractual obligation of the Taker to the Provider, the value of which is measured by reference (but only by reference) to the value of Eligible Margin Transferred to the Taker (along with other relevant property mentioned in the definition of "Margin Received"). Note, in particular, that the Taker is not required to "hold" the Margin Received in a literal sense and that therefore references in Sections 3.2(a)(i) and (ii) to Margin Received being "held by" the Taker should not be construed literally.

3. Representation. Each party represents in Section 3.3 in relation to any Transfer that it makes to the other party that it is the sole owner of the assets transferred, free and clear of any third party interest. This reinforces the intended Transfer of unencumbered ownership (or outright payment in the case of Cash) under Section 3.1(a) and helps to protect the transferee should a third party subsequently claim that the transferee had notice of its interest. As for Section 3.1(a), there is a carve-out for routine clearance system liens on securities.

4. Distributions. Section 3.4 deals with a purely technical drafting point. Under the title transfer approach, the margin taker becomes the owner of the margin assets transferred. It may, therefore, immediately sell them to a third party or dispose of them in some other way. Strictly speaking, the "margin" under the title transfer approach does not consist of those assets but of the conditional obligation of the Taker to return fungible equivalent assets to the Provider in due course, the condition being that the Provider continue to perform its Obligations.

Nonetheless, to implement the normal intention under a title transfer margin arrangement that the economic interest of the margin provider in income arising on the margin assets should be preserved, there needs to be a mechanism for attributing distributions arising on margin assets transferred under this approach to the margin taker.

26 See the discussion of this point in Part II.E of this Guide.

In the case of the Provisions, Section 3.4 achieves this by "deeming" the Taker to have received Distributions in relation to any Margin Received in the form of securities, whether or not it actually holds such securities in its securities account on the relevant Distributions Date.

D. Additional Elective Provisions

1. Overview of Part 4. As noted above, Part 4 was envisaged by the working group as a Part of the Provisions where jurisdiction-specific provisions could be included. The principle is that, within the context of an overarching legal approach and governing law, provisions could be included that would facilitate the creation of security or an effective title transfer arrangement in relation to margin in a particular jurisdiction. If necessary, these provisions would be governed by local law, as a carve-out from the principal governing law, assuming that having different governing laws applying to different parts of the overall contractual relationship between the parties is acceptable to the parties and their legal advisers.[27]

The only jurisdiction-specific provisions (other than, of course, the New York and English law provisions) on which the ISDA working group drafting the Provisions achieved a consensus prior to publication of the Provisions were the Japanese Margin provisions set out in Section 4.1 of the Provisions. As noted elsewhere in the Guide, ISDA contemplates the possibility of expanding Part 4 to add further Sections applicable to margin in other jurisdictions, if it is thought that such provisions would provide any important legal or operational advantages.

The benefits of applying Section 4.1 to Japanese Margin are discussed in the next section of this Guide.

2. Elective Provisions for Japanese Margin. Structurally under the Provisions the parties must first elect an overall legal approach and governing law and then, if Japanese Margin is involved in the arrangement, may elect to apply Section 4.1 to the Japanese Margin. If, however, the only margin involved in the arrangement is Japanese Margin, it should be relatively straightforward to adapt the Supplement so that Section 4.1 governs the whole margin arrangement, including the provisions of Part 1 and Part 5 of the Provisions. Parties wishing to do so, however, should confirm the advisability of this with their Japanese legal advisers. They may also wish to consider the issues mentioned in Part I.E of this Guide, if contemplating doing so in relation to an ISDA Master Agreement governed by New York or English law.

If Section 4.1 applies, then its provisions are to be construed in accordance with Japanese law, and the parties submit to the jurisdiction of the Japanese courts in connection with any related dispute.

a. *Characterisation of the Arrangement.* Each Transfer of Japanese Margin in the form of securities is characterised as a loan (*shohi-taishaku*) for purposes of Japanese law. Each Transfer of Japanese Margin in the form of Cash is characterised as a deposit (*shohi-kitaku*). One of the most important effects of this characterisation is that the Taker is entitled to use the Margin Received, provided that it has not itself defaulted, as though it were the outright owner of those assets.

Section 4.1 thus creates an arrangement comparable to the English law title transfer approach in Part 3. One structural difference, however, is that under Section 4.1(iii) the Taker may repay the Japanese Yen Cash equivalent of any Japanese Margin received in the form of securities. Under the English law title transfer approach,

27 See the discussion of this point in Part I.E of this Guide.

prior to a default, the Provider is always entitled, in the case of a Return Amount, to delivery of fungible assets of the same description as those it originally provided and specified in its margin call. In other words, the Taker does not have the right to deliver a Return Amount in the form of Cash if the Taker specified securities in its margin call. (If the Taker has not specified the Equivalent Margin to be delivered, however, then the Provider may choose the Equivalent Margin to be delivered up to, but not exceeding, the Return Amount.)

Under Section 4.1(iii), the right of the Taker to repay Cash in lieu of delivering fungible securities is, prior to a Close-out Date, subject to the prior written consent of the Provider. In practice, therefore, Part 3 and Section 4.1 do not differ substantially on this point. Under Section 4.1, however, the Taker's option to pay Cash in lieu of delivering fungible securities is important to the close-out mechanism in Section 4.1(b), discussed in sub-paragraph b below.

b. ***Event of Default or Specified Condition.*** Upon the occurrence of a Close-out Date, the Taker will be deemed to have elected to repay the Japanese Yen Cash equivalent of any Japanese Margin received in the form of securities. All Margin Received in the form of Japanese Margin will become immediately due and payable, but will subject to the right of the non-defaulting party to exercise a right of set-off between the Obligations of the Provider and the Value of the Japanese Margin Received. If Automatic Early Termination applies in relation to an ISDA Master Agreement, then this set-off will occur automatically.

Any excess Margin Received will be returned to the Provider, but subject to any other rights of set-off available to the Taker. The Provider will remain liable for any Obligations remaining after the set-off under Section 4.1(b)(ii) has been exercised.

c. ***Additional Events of Default.*** Section 4.1(c) includes additional Events of Default relating to (i) pre-judgement and post-judgement attachment and similar court orders made in relation to Japanese Margin Received or Obligations of a party and (ii) the Transfer, assignment or pledge by a party to a third party of any of (A) its rights to receive the Japanese Margin Received or (B) the Obligations.

IV. COMPLETING THE 2001 ISDA MARGIN SUPPLEMENT

To assist parties using the Provisions, set forth below is a more detailed discussion of the Supplement, including a Paragraph-by-Paragraph commentary.

While it is not strictly necessary to lay out the Supplement in the form set out in Appendix A to the Provisions, for the sake of efficiency and market standardisation, parties will generally find it convenient to do so, particularly when using the Provisions with an ISDA Master Agreement.

The discussion below refers to a "Supplement" when considering a hypothetical Supplement being completed, negotiated and/or entered into between two parties and refers to the form of Supplement in Appendix A to the Provisions when discussing the format of, or specific wording suggested in, the form of Supplement as published by ISDA with the Provisions. It is expected that most Supplements incorporating the Provisions will follow the suggested form of Supplement closely, including much of the specific wording suggested there. But the flexibility exists to depart from the form according to the needs of individual circumstances.

At the end of the discussion of each Paragraph of the Supplement, there is a list of cross-references that identifies the Parts or Sections of the Provisions that relate to or specifically cite the Paragraph discussed. A more detailed discussion of the purpose and effect of each Section of the Provisions and each defined term discussed or referred to below will be found in Parts II and III above. In this Part IV, we therefore focus primarily on the practical aspects of completing a Supplement.

Overview. As noted above, the Supplement is the basic operative document of a margin arrangement entered into under the Provisions. It allows the parties to make various elections and specify key variables as well as modify and supplement the Provisions in various ways. In this way, it is similar to Paragraph 13 of the New York Annex and Paragraph 11 of the English Annex.[28]

Parties will note that there are "fallback" provisions for various elections. These are intended in each case to reflect a common or at any rate reasonable choice in the absence of a specific election by the parties. For example, if the parties do not specify a Base Currency in Paragraph 3 of the Supplement, the fallback is U.S. Dollars. The use of fallback provisions is common in ISDA documentation and is intended to be helpful.

There are, however, a number of provisions for which there is no fallback. In relation to these, it is essential that the parties make an election or specification. Among other things, parties **must** select the following:

(1) the basic legal approach and governing law;

(2) the items that will constitute Eligible Margin;

28 Confirmations may be used to effect either general amendments to an ISDA Master Agreement, including the specification of elections or variables under the Supplement, or to make Transaction-specific amendments. Parties desiring to use a Confirmation to effect a general amendment should make that intent clear in the relevant Confirmation so as to avoid any implication that such changes will cease to apply once the Transaction covered by the Confirmation matures or is terminated. Before effecting a general amendment to an ISDA Master Agreement through the use of a Confirmation, parties should consider whether this approach could pose operational difficulties.

(3) where Cash may be held as Margin Received, parties must either (i) establish Interest Rates that will be applied to that Cash for each currency, determine whether interest will be simple or compounded and specify payment terms, or (ii) create their own procedures for the investment of that Cash; and

(4) the transfer instructions applicable to the items that constitute Eligible Margin.

Preamble. The preamble to the form of Supplement in Appendix A to the Provisions makes it clear that the Supplement "supplements, forms part of, and is subject to" the Agreements to which it relates.

Note that it is not only possible to use a Supplement incorporating the Provisions with an Agreement other than the ISDA Master Agreement, but it is possible to use one with two or more Agreements at the same time. In those circumstances, the Exposure is the aggregate of the Exposure calculated separately under each Agreement. As discussed in Part II.D.1 of this Guide, however, parties need to be sure that their aggregate exposure under all of such Agreements is net. This may require use of some form of "master master" or "umbrella" agreement.[29]

Thus the Supplement becomes a margin arrangement for various different trading relationships between the parties. This is sometimes referred to as "margin pooling" or "cross-margining".

The preamble also provides that in the event of an inconsistency:

(1) between the Supplement and the Provisions, the Supplement will prevail;

(2) between the Supplement and the rest of the Agreement(s) to which it relates, the Supplement will prevail; and

(3) between a Confirmation and the Supplement, the Confirmation prevails for purposes of the relevant Transaction.

Paragraph 1: Margin Approach. As discussed in Parts II.E and III above, parties must choose the legal approach and governing law applicable to the Supplement: the New York law security interest approach, the English law title transfer approach and/or the Japanese law loan collateral approach (with the possibility, as discussed above, of other local law legal provisions in future editions of the Provisions). Each approach is intended to work in conjunction with the operational provisions in Part 1 and the definitions in Part 5 of the Provisions.

Cross-References: Parts 2, 3 and 4.

Paragraph 2: Exposure. The Provisions assume that all Transactions under the related Agreement will be taken into account in the calculation of Exposure. This assumption is based on dominant practice and an awareness that omitting Transactions from the calculation of Exposure may unexpectedly increase risk in mark-to-market collateralisation.

Nonetheless, some market participants may wish to remove certain Transactions from the calculation of Exposure. The form of Supplement in Appendix A to the Provisions provides a location to accomplish this. As discussed above, any Transactions excluded in Paragraph 2 are

29 See also footnote 18 above.

excluded for purposes of the margin calculation only. As discussed in Part II.D.1 of this Guide, in the event of a default all margin then held by the Taker would be available to satisfy all Obligations of the Provider up to the limit of the Margin Received.

Parties are free to decide on what basis they will identify Transactions to be excluded from the calculation of Exposure. They may choose to exclude Transactions that fall within certain product categories, or, if one of the parties is a multibranch party, they may agree to exclude all Transactions booked in one or more branches of that party.

Whatever the principle of exclusion chosen (and the credit implications of any such exclusion should be carefully considered), the exclusion must be clear and certain in its scope. Careful drafting of Paragraph 2 of the Supplement is particularly important.

Cross-Reference: Section 5.20.

Paragraph 3: Base Currency. The "Base Currency" is defined as U.S. Dollars unless the parties specify otherwise.

Cross-Reference: Section 5.3.

Paragraph 4: Margin. Parties must specify the types of Eligible Margin that a party may deliver to satisfy a call for a Delivery Amount. They may do this in tabular form, as suggested in the form of Supplement in Appendix A to the Provisions. That form assumes that Eligible Margin will be in the form of Cash or securities. Securities should be specified by reference to the issuer and with any conditions as to remaining maturity that the parties may agree.

The parties should also specify a Valuation Percentage for each type of Eligible Margin. If no Valuation Percentage is specified, it is deemed to be 100%.

As discussed in Part II above, the application of a Valuation Percentage to a type of Eligible Margin has the effect, through the definition of "Value", of discounting the valuation of that item by an agreed amount. The amount of that discount is often referred to in the market as a "haircut" on the relevant type of Eligible Margin.

When completing Paragraph 4, it is important to remember that the Valuation Percentage and the "haircut" are complementary percentages. In other words, if the parties wish to apply a haircut of 5% to a U.S. Treasury not exceeding a certain maturity, they should specify a Valuation Percentage in relation to that U.S. Treasury of 95%.

Cross-References: Sections 5.14 and 5.49.

Paragraph 5: Structural Parameters. Paragraph 5 of the form of Supplement in Appendix A to the Provisions sets out a "Structural Parameters" matrix. The matrix allows the parties to specify in a straightforward way the Lock-up Margin, Additional Margin Amount, Threshold and Minimum Transfer Amount applicable to each party. Paragraph 5 also permits the parties to specify a rounding convention.

a. Lock-up Margin. Lock-up Margin is, in effect, initial margin due from a Provider to cover potential future exposure of the Taker between Valuation Dates. It may be due from a Provider to a Taker when there is no current Exposure of the Taker to the Provider. As discussed in Part II of this Guide, the Provisions do not indicate how Lock-up Margin is to be determined.

It may be a fixed amount in the Base Currency or it may be determined by reference to a formula. The formula may simply be the sum of a fixed amount per Transaction entered into, excluding (perhaps) Transactions under which the Taker would have no on-going potential Exposure, because, for example, the Provider has bought an option from the Taker for which it has paid an upfront premium.

If Lock-up Margin is not specified, it is deemed to be zero.

Lock-up Margin is to be transferred independently of the calculation of Margin Required. It is not subject to offset against any other delivery obligation of the Taker. As discussed in Part II (and subject to the caveat expressed there), the level of Lock-up Margin applicable to a party may be linked to the rating of the senior unsecured debt obligations of that party.

The form of Supplement in Appendix A to the Provisions sets out two elections, in a "tick the box" format, in which a Provider may demand return of Lock-up Margin it has provided. One is where the Provider has no present or future, absolute or contingent, Obligations to the Taker under the relevant Agreement(s). In other words, where the Taker has no potential future exposure to the Provider. The other case is where the Taker's Exposure has dropped below an agreed level, which could be expressed by reference to a fixed amount in the Base Currency or by reference to a formula.

Cross-References: Sections 1.1(c) and 5.27.

b. Additional Margin Amount. The Additional Margin Amount applicable to each party is normally a fixed amount in the Base Currency, as suggested in the form of Supplement in Appendix A to the Provisions. It may, however, instead be determined by reference to a formula and vary, for example, in accordance with the size and/or number of Transactions entered into under the related Agreement(s). If an Additional Margin Amount is not specified, it is deemed to be zero.

The Additional Margin Amount is an element in the calculation of Margin Required and therefore forms part of the variation margin mechanics of Sections 1.1(a) and (b) of the Provisions. The Additional Margin Amount is essentially the same as the concept of Independent Amount in the New York Annex and the English Annex.

Cross-References: Sections 5.1 and 5.30.

c. Threshold. The Threshold specified in relation to a party as Provider represents the amount of Exposure that the other party as Taker is willing to bear in relation to the Provider without holding any Margin Received. This is sometimes referred to commercially as the "permitted unsecured risk".

The parties may specify the Threshold as a fixed amount in the Base Currency (as suggested in the form of Supplement in Appendix A to the Provisions) or, less commonly, as a formula. The Threshold is sometimes linked to the credit quality of the Provider so that it is lowered, perhaps to zero, if the rated senior unsecured debt obligations of the Provider are downgraded or cease to be rated.[30] Conversely, the Threshold may be raised if the Provider's rated debt is upgraded to an agreed level.

For purposes of determining Margin Required in relation to a Provider on a Valuation Date as of the Valuation Time, the Taker determines its Exposure, adds the Additional Margin Amount applicable to the Provider and subtracts the Additional Margin Amount applicable to itself, and then compares the resulting amount (which will be expressed in the Base Currency) to the Threshold applicable to the Provider. If the resulting amount exceeds the Threshold, the Margin Required equals the excess amount. If it does not, then there is no Margin Required on that Valuation Date from the Provider.

Examples:

(1) A Taker has an Exposure of EUR 4,900,000 to the Provider. The Provider's Threshold is EUR 5,000,000. There are no Additional Margin Amounts specified in relation to either party. In such a case, the Taker's Exposure does not exceed the Provider's Exposure, and therefore there is no Margin Required from the Provider.

(2) On the next Valuation Date, the Taker's Exposure has risen to EUR 5,100,000. The Taker's Exposure now exceeds the Threshold by EUR 100,000, which becomes the Margin Required from the Provider in relation to that Valuation Date.

Note that Margin Required, if any, is only the excess over the Threshold. In other words, it is not the case that once the Threshold is exceeded, the entire amount of the Taker's Exposure is collateralised. It remains exposed to the Provider up to the amount of the Threshold. If the parties wish to provide, however, that once the permitted unsecured risk has been exceeded, full margining is triggered, they can do so by adding appropriate drafting to that effect in the Supplement.

Cross-References: Sections 1.1 and 5.43.

d. Minimum Transfer Amount. In order to avoid the need to transfer an inconveniently small amount of variation margin in relation to any Valuation Date, the parties may specify a Minimum Transfer Amount in relation to each party. This will normally be a fixed amount in the Base Currency, as suggested in the form of Supplement in Appendix A to the Provisions.

The Minimum Transfer Amount need not be the same for each party. For example, if one party is of a substantially lower credit quality than the other party, then its Minimum Transfer Amount might be set at quite a low level. As noted above in relation to Threshold, a Taker may wish to link the level of Minimum Transfer Amount applicable to the Provider to the rating of its senior unsecured debt obligations so that if

30 The legal advisers of the Taker should ensure, however, that such a link will not render this provision, or any other aspect of the margin arrangement, vulnerable under preference or similar insolvency rules in the event of the Provider's insolvency in its jurisdiction of organisation.

such obligations are downgraded or cease to be rated, the Minimum Transfer Amount will be lowered, possibly to zero.[31]

If no Minimum Transfer Amount is specified, it is deemed to be zero. The Minimum Transfer Amount is not an element in the calculation of Margin Required, Delivery Amount or Return Amount. Instead, it is applied once a Delivery Amount or Return Amount has been calculated in order to determine whether such an amount needs to be delivered. Once the Minimum Transfer Amount is reached or exceeded in relation to a margin call, the Call Recipient is obliged to transfer the full amount of margin required (that is, the relevant Delivery Amount or the Return Amount).

> *Example*: On a Valuation Date, a Taker determines that a Delivery Amount is due from the Provider in the amount of JPY 4,000,000. The Provider's Minimum Transfer Amount, however, is JPY 5,000,000. Hence the Provider is not obliged to Transfer a Delivery Amount in respect of that Valuation Date. On the next Valuation Date, however, the Taker determines a Delivery Amount due from the Provider of JPY 10,000,000 in which case the Taker is obliged to transfer the full JPY 10,000,000 to the Taker and not merely the excess of the Delivery Amount over the Minimum Transfer Amount.

Because the use of Minimum Transfer Amount only establishes a "floor," it does not eliminate the possibility that parties will be required to deliver uneven amounts of Eligible Margin or Margin Received, which is instead dealt with by use of a rounding convention.

Note that Minimum Transfer Amount does not apply to Transfers of margin in relation to Lock-up Margin or Substitutions or to Transfers of Distributions, Interest Amounts or amounts to be transferred under the dispute resolution procedures (other than an Undisputed Amount).

Cross-References: Sections 1.1 and 5.31.

e. ***Rounding.*** Parties may establish a rounding convention to avoid the obligation to deliver margin in an amount that is otherwise uneven (for example, USD 1,501,198.12) or difficult to obtain in the form requested (for example, an odd nominal amount of securities).

Parties may specify a rounding convention of their own devising or select one of the following possibilities suggested in the form of Supplement in Appendix A to the Provisions: (i) round each Delivery Amount and Return Amount down to the nearest integral multiple specified; or (ii) round each Delivery Amount up and each Return Amount down to the nearest integral multiple specified.

If no rounding convention is specified, then the Delivery Amount and the Return Amount will not be rounded.

31 The legal advisers of the Taker should ensure, however, that such a link will not render this provision, or any other aspect of the margin arrangement, vulnerable under preference or similar insolvency rules in the event of the Provider's insolvency in its jurisdiction of organisation.

Parties would not ordinarily be expected to specify that both Delivery Amounts and Return Amounts are to be rounded up, as this could create conflicting obligations to transfer collateral and result in a Taker being undersecured.

> *Example*: The parties have specified that Delivery Amounts and Return Amounts will be rounded up to the nearest multiple of USD 1,000. No Minimum Transfer Amount is specified in relation to either party. On a Valuation Date, the Margin Required from the Provider is USD 11,100 and the Margin Received by the Taker is zero. As a result of the rounding convention, the Delivery Amount due is USD 12,000. On the next Valuation Date, if the Margin Required remains USD 11,100, the Margin Received exceeds the Margin Required by USD 900. After rounding, this becomes a Return Amount due to the Provider of USD 1,000, leaving the Taker undersecured by USD 100.

In the past, parties have also used the rounding convention as a substitute for Minimum Transfer Amounts. Although a rounding convention certainly may be used in this way (see, for example, the discussion of rounding in the User's Guide to the 1994 ISDA Credit Support Annex), many ISDA members have found this practice to be operationally inconvenient. It is suggested that the better practice is to use Minimum Transfer Amounts to address the size of potential Transfers of Delivery Amounts and Return Amounts and to use the rounding convention simply to produce round Transfer amounts. In other words, the better practice is to use each concept as it was originally intended to be used.

Note that any agreed rounding convention does not apply to Transfers of margin in relation to Lock-up Margin or Substitutions or to Transfers of Distributions, Interest Amounts or amounts to be transferred under the dispute resolution procedures (other than an Undisputed Amount).

Cross-Reference: Section 1.1.

Paragraph 6: Dispute Resolution - Dispute Termination Event. Under each of the two dispute resolution procedures outlined in Section 1.6(b) and Section 1.6(c), one possible consequence of a failure to resolve the dispute is that either party may declare a Dispute Termination Event, resulting in the early termination of all Transactions under the related Agreement(s) on a no-fault basis, each Transaction to be closed out at mid-market valuations. A Dispute Termination Event may only be declared, however, if it is specified as applicable in the Supplement.

Paragraph 6 of the form of Supplement in Appendix A to the Provisions is drafted so that Dispute Termination Event will not apply, unless the parties specify otherwise. In other words, if the parties do not deal with this point in the Supplement, then the presumption is that Dispute Termination Event is not applicable.

Cross-References: Sections 1.6(b)(v)(F), 1.6(c)(v)(B)(2) and 5.11.

Paragraph 7: Dispute Resolution - Value. If a Calling Party disputes the Value of any margin Transferred to it in response to a margin call, Section 1.6(c)(ii) requires that the Call Recipient recalculate the Value of the margin Transferred using any undisputed values set forth in the Notice of dispute and in accordance with the procedures (if any) in the Supplement.

Paragraph 7 of the form of Supplement in Appendix A to the Provisions sets out one such possible procedure, namely, that the Value will be re-calculated "based on the higher of the bid price quoted by the Call Recipient or the offer price quoted by the Calling Party, in each case on the basis of a purchase by the Call Recipient from or a sale by the Calling Party to, independent third party dealers in the relevant security".

This manner of determining the price is thought to be fair because it balances (a) the Call Recipient's normal incentive to claim the highest possible Value for a Transfer of a particular security as margin against (b) the Call Recipient's normal incentive, when purchasing the same security from an independent third party, to pay the lowest purchase price for which it can get the security. Likewise, this approach balances (x) the Calling Party's normal incentive to ascribe the lowest possible Value to a Transfer of margin it has received against (y) the Calling Party's normal incentive, when selling the same security to an independent third party, to sell it at the highest sale price it can obtain.

As between the Call Recipient's bid price and the Calling Party's offer price, the working group that prepared the Provisions considered that the higher of the two prices was fair to both parties, but parties are, of course, free to take another approach. This manner of determining the price, of course, only applies to margin in the form of securities and works best if each of the parties trades or is capable of trading the securities in the normal course of its business. The Values ascribed by each party to the relevant Margin are tested against the market, which therefore assures the fairness of the final result.

If using the wording set out in Paragraph 7 in the form of Supplement in Appendix A to the Provisions, parties may wish, for the sake of clarity, to delete the words "Eligible Margin or Margin Received" in the second line and to replace them with the words "any relevant margin in the form of a security".

In the absence of a stipulated procedure in the Supplement for purposes of Section 1.6(c)(ii), the Call Recipient will be obliged to make its recalculation in good faith and in a commercially reasonable manner, as required by Section 1.10(f).

Cross-Reference: Section 1.6(c).

Paragraph 8: Consent to Substitution.

The Provider must obtain the Taker's consent to any substitution under Section 1.7(d) if such a consent requirement is specified as applicable in the Supplement. Paragraph 8 of the form of Supplement in Appendix A to the Provisions provides an appropriate form of wording.

In the absence of any such specification, the consent requirement will <u>not</u> apply. For the avoidance of doubt, parties may prefer in such a case to specify in Paragraph 8 that the consent requirement is inapplicable.

Neither Section 1.7 nor Paragraph 8 of the form of Supplement in Appendix A to the Provisions specifies the manner in which consent must be given, for example, whether consent must be in writing or may be given orally. In the absence of any specific limitation in this regard, it may be presumed that consent may be given in any reasonable manner.

Where parties wish to have the consent requirement apply, however, for specific commercial or legal reasons, those reasons may also influence the manner and procedure for obtaining consent to substitution. Any such manner or procedure may be specified in Paragraph 8 of the Supplement.

It is perhaps worth noting that Paragraph 8 is the only Paragraph of the Supplement referred to <u>by number</u> in the Provisions. If the parties choose to depart from the Paragraph numbering of the form of Supplement in Appendix A to the Provisions, they may want to delete the words "Paragraph 8 of" in Section 1.7(d).

Cross-Reference: Section 1.7.

Paragraph 9: Interest Rate, Interest Amount and Interest Period. The parties should specify in Paragraph 9 of the Supplement the Interest Rate that will apply to Margin Received in the form of Cash in each currency and, subject to certain conditions, paid to the Provider under Section 1.8(c) of the Provisions.

Of course, it is possible for the parties to agree that no Interest Amounts will be paid on Cash Margin Received. One way of achieving this would be to specify zero as the Interest Rate in relation to each currency in Paragraph 9 of the Supplement.

Under Section 1.8(c) and Section 5.22 of the Provisions, the Interest Amount for any Interest Period is the sum of the daily interest calculations using the equivalent of an Actual/360 day count fraction (or, if such currency is pounds sterling, 365). Unless the parties specify otherwise, Interest Amounts will be calculated on a simple basis.

Finally, the parties specify in Paragraph 9 of the Supplement the Interest Period end dates. Two possibilities are suggested, one being the first calendar day of each month and the other being any date on which a Return Amount consisting wholly or partly of Cash is Transferred to the Provider pursuant to Section 1.1(b). Either or both of these could apply, or the parties could specify other alternatives.

Cross-References: Sections 1.8(c), 5.22, 5.23 and 5.24.

Paragraph 10: Demands and Notices. All demands and notices to be made under the Supplement are to be made pursuant to the Notices Section(s) of the related Agreement(s), unless otherwise specified in the Provisions or in the Supplement.

Cross-References: Sections 1.10(c) and (d).

Paragraph 11: Transfer Information. Parties should identify in Paragraph 11 where transfers of Eligible Margin, Interest Amount (if applicable) and Equivalent Margin should be paid or delivered, as the case may be.

Cross-Reference: Section 5.45.

Paragraph 12: Conditions Precedent and Rights and Remedies. Parties may specify Specified Conditions for purposes of the conditions precedent in Section 1.2 of the Provisions, the "Use of Margin Received" provision in Section 2.2 of the Provisions and the enforcement provisions of Parts 2 and 3 and Section 4.1 of the Provisions. While any relevant event or condition may be specified, typically a Specified Condition will be a no-fault termination event in an Agreement collateralised by the Supplement. In the case of an ISDA Master Agreement, for example, this could include any of the Termination Events specified in the ISDA Master Agreement.

Cross-References: Sections 1.2, 2.2, 2.4, 3.2 and 5.40.

Paragraph 13: Obligations. "Obligations" is the term used in the Provisions to describe all present and future obligations of a party under the related Agreement(s), including under the Supplement itself.

Note that the parties may expand the scope of "Obligations" to include obligations arising under agreements other than the Agreement(s) to which the Supplement relates. Although the determination of the Margin Required would remain limited to the Exposure of each party as Taker under the related Agreement(s), the expansion of "Obligations" means that a Taker could apply any Margin Received against the additional obligations specified. In practice, the Taker would apply Margin Received first to its net Exposure to the Provider and then any remaining Margin Received to the additional obligations. The Provisions, however, do not require that the Obligations be discharged in this order.

Cross-Reference: Section 5.36.

Paragraph 14: Eligibility to Hold Margin Received; Custodians. This Paragraph is only applicable to the New York law security interest approach set out in Part 2 of the Provisions.[32]

Under Section 2.2(b), the Taker and its specified Custodian (if any) will be entitled to hold Margin Received provided that it satisfies the conditions specified in the Supplement. Two such conditions are set out in Paragraph 14 of the form of Supplement in Appendix A to the Provisions as a "tick the box" election.

One condition is that no Event of Default has occurred in respect of Party A. This condition is likely to be elected by parties as a matter of course. The other condition suggested in the form of Supplement in Appendix A to the Provisions is that Margin Received may only be held in certain specified jurisdictions. The form of Supplement in Appendix A to the Provisions, of course, leaves the choice of jurisdictions to be filled in by the parties according to their own circumstances. If parties choose to make this election, they may specify specific countries (or specific legal jurisdictions within those countries; for example, New York in the relation to the

32 Under the English law title transfer approach set out in Part 3 of the Provisions and the Japanese law loan collateral approach set out in Section 4.1 of the Provisions, the Taker, as owner of securities transferred to it as margin, is able to hold that property as it sees fit, either directly or with any custodian or other third party.

U.S. or England or Scotland in relation to the U.K.). Alternatively, they may prefer to specify that Margin Received may be held in "any jurisdiction where [Party A/B] has a branch" or in some other more general way.

Other appropriate conditions may be added in relation to either party or its Custodian (if any). If a party has a Custodian, then it may be specified in the Supplement, as suggested in Paragraph 14 of the form of Supplement in Appendix A to the Provisions.

Cross-Reference: Section 2.2(b).

Paragraph 15: Use of Margin Received. This Paragraph is only applicable to the New York law security interest approach set out in Part 2 of the Provisions.[33]

Under Section 2.2(c), the Taker has the right to use Margin Received as set forth in Section 2.2(c)(i) and (ii) unless otherwise provided in the Supplement. In other words, the right of the Taker to use the Margin Received is presumed unless the parties specifically elect to the contrary.

Paragraph 15 of the form of Supplement in Appendix A to the Provisions sets out in a "tick the box" format the possibility of disapplying this right of use in relation to one or both parties. In addition, the parties may specify certain restrictions or conditions on the use of any Margin Received by one or both parties as Taker.

Cross-Reference: Section 2.2(c).

Paragraph 16: Other Provisions. Paragraph 16 provides the parties with a place to include modifications to specific clauses of the Provisions as well as supplemental provisions, much like Part 5 of the Schedule to the ISDA Master Agreement.

As with the Schedule, parties should consider carefully whether the benefits of any such modifications or supplemental provisions outweigh the potential disadvantages of departing from the standard provisions. Such modifications or supplemental provisions generally lengthen the document and sometimes make it more complex. This can, in turn, make the document more difficult to negotiate and, once executed between the parties, may make it more difficult to operate in practice.

The flexibility offered by Paragraph 16 of the Supplement does, however, give the parties the ability to customise their margin arrangements to reflect any unusual circumstances or special requirements relevant to their trading relationship.

Signature Blocks. The form of Supplement in Appendix A to the Provisions includes signature blocks. As noted above, where the Supplement is used with an ISDA Master Agreement, it forms part of the ISDA Master Agreement and therefore does not necessarily need to be signed separately, although local legal advice should be taken on this point in the jurisdiction of organisation of each party and in each jurisdiction of location of margin assets. Many parties may feel more comfortable signing the Supplement separately, even where it is not strictly necessary to do so.

33 Under the English law title transfer approach set out in Part 3 of the Provisions and the Japanese law loan collateral approach set out in Section 4.1 of the Provisions, the Taker becomes the owner of securities transferred to it as margin and is therefore, of course, able to use that property without restriction.

APPENDIX A

FORM OF AMENDMENT TO ISDA MASTER AGREEMENT TO ADD THE 2001 ISDA MARGIN SUPPLEMENT

Parties should consult with their legal advisers and any other adviser they deem appropriate prior to using this form of Amendment. Because of the varied documentation structures in the marketplace, modifications to this form of Amendment may be necessary or an entirely different form of amendment may be appropriate.

AMENDMENT TO ISDA MASTER AGREEMENT

dated as of ....

.... and ....

have entered into an ISDA Master Agreement, dated as of ...., as amended and supplemented from time to time (the "Agreement").

The parties have agreed to amend the Agreement as follows:

1. Amendment of the Agreement [and amendment and restatement of Credit Support Annex][34]

Upon execution of this Amendment by both parties, the Agreement is amended to [add as part of the Schedule to the Agreement the 2001 ISDA Margin Supplement in the form set out in the Exhibit attached to this Amendment.] [amend and restate the Credit Support Annex currently forming part of the Schedule to the Agreement in the form of the 2001 ISDA Margin Supplement set out in the Exhibit attached to this Amendment.][35]

2. Representations

Each party represents to the other party that all representations contained in the Agreement (including all representations set out in the Annex) are true and accurate as of the date of this Amendment and that such representations are deemed to be given or repeated by each party, as the case may be, on the date of this Amendment.

---

34 Delete unless amending and restating an existing 1994 ISDA Credit Support Annex or 1995 ISDA Credit Support Annex. Note that this provision is drafted to amend and restate, rather than discharge, an existing Credit Support Annex in order to minimise the risk that a new margin arrangement is deemed to be created by this Amendment for purposes of preference or similar rules under any relevant bankruptcy or insolvency law.

35 Use second of these alternatives if amending and restating an existing 1994 ISDA Credit Support Annex or 1995 ISDA Credit Support Annex.

3. Miscellaneous

(a) **Definitions.** Capitalised terms used in this Amendment and not otherwise defined shall have the meanings specified for such terms in the Agreement.

(b) **Entire Agreement.** This Amendment constitutes the entire agreement and understanding of the parties with respect to its subject matter and supersedes all oral communication and prior writings (except as otherwise provided in this Amendment) with respect to its subject matter.

(c) **Counterparts.** This Amendment may be executed and delivered in counterparts (including by facsimile transmission), each of which will be deemed an original.

(d) **Headings.** The headings used in this Amendment are for convenience of reference only and are not to affect the construction of or to be taken into consideration in interpreting this Amendment.

(e) **Governing Law.** This Amendment will be governed by and construed in accordance with [English law][the laws of the State of New York (without reference to choice of law doctrine)].[36]

IN WITNESS WHEREOF the parties have entered into this Amendment on the respective dates specified below with effect from the date specified on the first page of this Amendment.

....	....
(Name of Party)	(Name of Party)
By:..	By..
Name:	Name:
Title:	Title:
Date:	Date:

Exhibit to be attached by the parties setting out an appropriately completed form of 2001 ISDA Margin Supplement.

36 Delete as applicable.

APPENDIX B

EXAMPLE ILLUSTRATING CALCULATION OF DELIVERY AMOUNT AND RETURN AMOUNT

Assumptions:

Counterparty A:

Threshold $10,000,000
Minimum Transfer Amount $1,000,000
Rounding $100,000
Additional Margin Amount $5,000,000

Counterparty B:

Threshold $25,000,000
Minimum Transfer Amount $5,000,000
Rounding $100,000
Additional Margin Amount $0

	Counterparty A's calculation (assuming Counterparty A is the Taker) See Note 3	Counterparty B's calculation (assuming Counterparty B is the Taker) See Note 3
Day 1 **- Assume Counterparty A exposed $57,255,361; no previous margin provided by either party**		
Exposure for a party (positive value if payable to that party; negative value if payable by that party)	57,255,361	<57,255,361>
+ Additional Margin Amount for Provider	0	5,000,000
– Additional Margin Amount for Taker	<5,000,000>	<0>
– Provider's Threshold	<25,000,000>	<10,000,000>
= Margin Required ("x") (if negative value, deemed to be zero - see Note 2)	27,255,361	0
Margin Received ("y")	0	0
Delivery Amount <Return Amount> (x minus y) - see Note 4	27,300,000	0
Margin Received (after delivery of Delivery Amount/Return Amount)	27,300,000	0

Day 2 **- Assume Counterparty B exposed $9,503,596; Delivery Amount for Day 1 has been received by the Taker**		
Exposure for a party (positive value if payable to that party; negative value if payable by that party)	<9,503,596>	9,503,596
+ Additional Margin Amount for Provider	0	5,000,000
– Additional Margin Amount for Taker	<5,000,000>	<0>
– Provider's Threshold	<25,000,000>	<10,000,000>
= Margin Required ("x")	0	4,503,596
Margin Received ("y")	27,300,000	0
Delivery Amount <Return Amount> (x minus y) - see Note 4	<27,300,000>	4,600,000
Margin Received (after delivery of Delivery Amount/Return Amount)	0	4,600,000
Day 3 **- Assume Counterparty B exposed $8,856,781 m; Delivery Amount for Day 2 has been received by the Taker; Return Amount for Day 2 has been received by the Provider**		
Exposure for a party (positive value if payable to that party; negative value if payable by that party)	<8,856,781>	8,856,781
+ Additional Margin Amount for Provider	0	5,000,000
– Additional Margin Amount for Taker	<5,000,000>	<0>
– Provider's Threshold	<25,000,000>	<10,000,000>
= Margin Required ("x") (if negative value, deemed to be zero - see Note 2)	0	3,856,781
Margin Received ("y")	0	4,600,000
Delivery Amount <Return Amount> (x minus y) - see Note 4	0	<700,000>
Margin Received (after delivery of Delivery Amount/Return Amount) - see Note 5	0	4,600,000

Notes:

1. *This Appendix does not address Lock-up Margin.*

2. *For avoidance of doubt, parties may wish to amend the definition of "Margin Required" to clarify that Margin Required will be deemed to be zero whenever the calculation of Margin Required yields a number less than zero. See Part II.D.4 of this Guide.*

3. *For these purposes, the Taker is the party holding Margin Received or demanding the Delivery Amount. The Provider is the other party.*

4. *For purposes of this Appendix B, it is assumed that the rounding convention chosen by the parties is to round the Delivery Amount up and the Return Amount down to the nearest integral multiple of $100,000.*

5. *Since the Return Amount is less than the Taker's (that is, Counterparty B's) Minimum Transfer Amount of $5 m, Counterparty B does not have to transfer the Return Amount. See Section 1.1(b) of the Provisions.*

APPENDIX C

SUMMARY OF TIMING OF TRANSFERS OF MARGIN - SECTION 1.3

***Note**: In this table, each day is a Margin Business Day and each time is the local time in the location of the Call Recipient, except where expressly stated otherwise. Each time is the latest time by which the specified action should occur or Notice should be received.*

If a demand for Transfer of margin is received after 10:00 a.m. (the Notification Time) on a Margin Business Day, it is deemed to have been received before 10:00 a.m. on the next Margin Business Day (unless superseded by a subsequent demand prior to that time).

<table>
<tr><th>Time</th><th>Day 1</th><th>Settlement Date</th></tr>
<tr><td>10:00 a.m.</td><td>Calling Party
makes demand for Transfer of margin</td><td></td></tr>
<tr><td>5:00 p.m.</td><td>Call Recipient
Initiates Transfer of the margin
provides Notice of:
type of margin it is Transferring; and
Settlement Date for such margin
If Notice of transfer is not given, the Calling Party may either:
give Notice of failure and request remedy by specified time and day, or
give Notice of failure declaring an Event of Default if not cured by next Margin Business Day</td><td>Transfer must be completed by 5:00 p.m. in the location of the account of the Calling Party

If Transfer is not completed, the Calling Party may either:
give Notice of failure and request remedy by specified time and day, or
give Notice of failure, declaring an Event of Default if not cured by next Margin Business Day</td></tr>
</table>

APPENDIX D.1

SUMMARY OF PROCEDURES FOR DISPUTE RESOLUTION - SECTION 1.6(b)

Dispute of Delivery Amount or Return Amount

***Note**: In this table, each day is a Margin Business Day and each time is the local time in the location of the Call Recipient. Each time is the latest time by which the specified action should occur or Notice should be received. Note that under Section 1.6(b) of the Provisions, the Call Recipient is the Disputing Party.*

Time	Day 1	Day 2	Day 3

10:00 a.m.	**Calling Party**
	makes demand for Transfer of margin
		Calling Party
		• reviews Portfolio Information received; and
		• transmits Notice of
		  • details of differences in Portfolio Information and
		  • Calling Party's Valuation Data	

1:00 p.m.	**Call Recipient** issues Notice of dispute	**Call Recipient** provides requested information or evidence, including the Call Recipient's Valuation Data	

5:00 p.m.	**Call Recipient**
	• Initiates Transfer of Undisputed Amount (if it exceeds the Minimum Transfer Amount) and
	• transmits Portfolio Information
		If dispute still **not** resolved:
		• if dispute concerns Exposure or Value of Margin Received, each party **selects one independent reference source**
		• if dispute concerns existence or characteristics of a Transaction, parties may choose to:
		  • continue the negotiations
		  • seek such other remedy as each in its discretion determines
			Independent reference sources to determine Exposure or Value and report determination to both parties and arithmetic average prevails
			If dispute remains, parties may choose to:
			• continue the negotiations
			• seek such other remedy as each in its discretion determines, or
			• if Dispute Termination Event is applicable, terminate the disputed Transaction(s)

If the dispute is resolved as a result of these procedures:

- by 5:00 p.m. on Day 2, then the Call Recipient must Transfer the balance of margin due (without regard to the Minimum Transfer Amount) by 5:00 p.m. on the relevant Settlement Date as if in response to a demand received by 10:00 a.m. on Day 3
- by 5:00 p.m. on Day 3, then the Call Recipient must Transfer the balance of margin due (without regard to the Minimum Transfer Amount) by 5:00 p.m. on the relevant Settlement Date as if in response to a demand received by 10:00 a.m. on Day 4

APPENDIX D.2

SUMMARY OF PROCEDURES FOR DISPUTE RESOLUTION - SECTION 1.6(c)

Dispute of Value of Transfer

***Note**: In this table, each day is a Margin Business Day and each time is the local time in the location of the Calling Party. Each time is the latest time by which the specified action should occur or Notice should be received. Note that under Section 1.6(c) of the Provisions, the Calling Party is the Disputing Party.*

Time	Day 1	Day 2	Day 3
10:00 a.m.	**Calling Party** makes demand for Transfer of margin		**Call Recipient** • recalculates Value of margin Transferred • notifies Calling Party of results
1:00 p.m.		**Calling Party** issues Notice of dispute	
5:00 p.m.	**Call Recipient** Initiates Transfer		**If dispute is resolved, Call Recipient** Initiates Transfer of any additional margin required as a result of recalculation (Minimum Transfer Amount does **not** apply) **If dispute remains,** parties may choose to: • continue the negotiations • seek such other remedy as each in its discretion determines, or • if Dispute Termination Event is applicable, terminate the disputed Transaction(s)

APPENDIX E

SUMMARY OF PROCEDURES FOR SUBSTITUTIONS - SECTION 1.7

***Note**:* *In this table, each day is a Margin Business Day and each time is the local time in the location of the Taker. Each time is the latest time by which the specified action should occur or Notice should be received.*

If a Substitution Notice is received after 5:00 p.m. on Day 1, it is deemed to have been received before 5:00 p.m. on next Margin Business Day (which becomes Day 1 for purposes of the table below).

Time	Day 1	Margin Business Day on which Taker confirms receipt of Substitute Margin
1:00 p.m.	**Subject to consent of Taker, if required in Supplement, Provider** Initiates Transfer of Substitute Margin (or on any subsequent Margin Business Day)	**Taker** confirms receipt of Substitute Margin at or before 1:00 p.m.
5:00 p.m.	**Provider** transmits Substitution Notice	**Taker** Initiates Transfer of Equivalent Margin **If receipt of Substitute Margin was confirmed after 1:00 p.m., Taker** Initiates Transfer of Equivalent Margin by 5:00 p.m. on next Margin Business Day

APPENDIX F

TABLE COMPARING TERMINOLOGY OF THE PROVISIONS WITH TERMINOLOGY USED IN THE CREDIT SUPPORT DOCUMENTS

As discussed in the main text of this Guide, a number of key terms in the Provisions are different from their equivalent terms in the New York Annex and/or the English Annex. The idea was to use terminology closer to commercial usage, and therefore more transparent.

Some terms are the same in all three documents, although, as noted after the table, this does not necessarily mean that the terms are identical in scope or effect in all three documents. The terms that are the same are: Delivery Amount, Exposure, Minimum Transfer Amount, Return Amount and Threshold.

The Provisions	The New York Annex	The English Annex
Additional Margin Amount	Independent Amount	Independent Amount
Base Currency		Base Currency
Call Recipient[37]		
Calling Party[38]		
Eligible Margin	Eligible Credit Support	Eligible Credit Support
Equivalent Margin	Posted Credit Support	Equivalent Credit Support
Lock-up Margin		
Margin Business Day	Local Business Day	Local Business Day
Margin Received	Posted Credit Support	Credit Support Balance
Margin Required	Credit Support Amount	Credit Support Amount
Margin Supplement	Credit Support Annex	Credit Support Annex
Provider	Pledgor	Transferor
Taker	Secured Party	Transferee

Note: *This table (which is not exhaustive) is intended for general guidance only, to assist those familiar with the current forms to orient themselves rapidly in the Provisions.*

A number of the defined terms in the Provisions have been modified substantially relative to their "equivalents" in the earlier documents. Also, the context in which the terms are used has also often been substantially modified in the Provisions relative to the earlier documents. This is particularly true, for example, in relation to Local Business Day in the Credit Support Documents, which becomes Margin Business Day in the Provisions.

Also note that terms such as "Pledgor" in the New York Annex and "Transferor" in the English Annex, while functionally equivalent, are different as a matter of legal substance due to the differing legal basis of each of these documents (security interest in the New York Annex, title transfer in the English Annex).

Where a box has been shaded, there is no functionally equivalent defined term in that document.

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37 Although there is no comparable defined term in either the New York Annex or the English Annex, the latter two forms, of course, include this concept in generic terms.

38 See prior footnote.

APPENDIX G

TABLE COMPARING KEY ELEMENTS OF THE PROVISIONS WITH THE NEW YORK ANNEX

Note: *This table (which is not exhaustive) is intended for general guidance only, to highlight the principal substantive similarities and differences between the Provisions and the New York Annex. For a summary of the principal similarities and differences in terminology, see Appendix F.*

One general difference highlighted above in this Guide is the fact that the Provisions may be used to collateralise exposures under a non-ISDA Agreement and under more than one (ISDA and/or non-ISDA) Agreement, whereas the New York Annex is designed for use only with an ISDA Master Agreement. This table, for simplicity and clarity, assumes use of each document only with an ISDA Master Agreement.

	The Provisions	**The New York Annex**
Architecture of the document when used with an ISDA Master Agreement	The Provisions are incorporated by reference into a form of Supplement, which is annexed to the related ISDA Master Agreement. The Supplement sets out the elections and variables of the parties, including the choice of governing law and legal basis, as well as any modifications to the Provisions.	The New York Annex is annexed to the related ISDA Master Agreement. Paragraph 13 to the New York Annex sets out the elections and variables of the parties as well as any modifications to the other provisions of the New York Annex.
Governing law and legal basis	The Provisions provide a choice of governing laws, as outlined in the text of this Guide. The choice of the New York law security interest approach in Part 2 of the Guide to govern a Supplement incorporating the Provisions creates a document equivalent to the New York Annex.	The New York Annex is based on the creation of a security interest under New York law. The application of New York law is assumed, based on the choice made by the parties in Part 4 of the Schedule to the ISDA Master Agreement. There is no separate governing law clause in the New York Annex.
Calculation of Delivery Amounts and Return Amounts	The calculation of Delivery Amounts and Return Amounts is essentially the same in both documents.	
Lock-up Margin	The Provisions provide for initial margin in the form of the Lock-up Margin. Lock-up Margin is determined separately from Delivery Amounts and Return Amounts and may not be off-set against those amounts or any other amount of Lock-up Margin or Margin Received. Lock-Up Margin may be due from a Provider even when the Taker has no Exposure, and each party may hold Lock-up Margin from the other party at the same time.	There is no concept in the New York Annex equivalent to Lock-up Margin.

Transfer timing	See Appendix C.	Under the New York Annex, transfers must be completed by close of business on the next Local Business Day after the relevant demand (if received before the Notification Time). This is possible (in contrast to the English Annex) because the New York Annex was drafted in contemplation of U.S. Dollar cash and U.S. government securities, where such timings are feasible.
Valuation of margin	Cash is valued at its face value less any applicable "haircut" (by multiplying the cash amount by any specified Valuation Percentage). Securities are valued at the bid price obtained by the determining party <u>plus accrued income</u> less any applicable "haircut".	Valuation of cash and securities is essentially the same in the New York Annex as in the Provisions, except that in the New York Annex accrued income is not expressly included (although it may already be reflected in the relevant bid price).
Valuation of exposure	Although there is a slight technical difference in the drafting of the definition of "Exposure" in each document, the valuation of Exposure is substantially the same.	
Who determines valuations	Valuations of Delivery Amounts and Return Amounts are made by the Calling Party. Valuation of Equivalent Distributions and Interest Amounts are made by the relevant Taker.	The Valuation Agent, which may be specified in Paragraph 13. In practice, this would be the calling party in relation to Delivery Amounts and Return Amounts and the Secured Party in relation to Equivalent Distributions and Interest Amounts. So in practice the two documents would work the same in this regard.
Dispute resolution	See Appendices D.1 and D.2. The dispute resolution procedure in the Provisions is intended to be more rigorous and allow less flexibility for delaying tactics than under the New York Annex. The principal sanction for delay is that the delaying party will be deemed to agree with the determination of the other party. Also the procedure for disputes regarding the amount of margin to be delivered is distinguished from the procedure for disputes regarding the value of margin that was delivered.	Although set out as a single procedure, the dispute resolution provisions of the New York Annex distinguish between disputes regarding margin calls and disputes regarding the value of margin delivered. The procedure in the New York Annex proceeds along a more relaxed timeframe than in the Provisions, and there are no specific sanctions if those timeframes are not respected.
Substitutions	See Appendix E. The key difference between the Provisions and the New York Annex in this regard is that the timing of transfers in connection with a substitution has been considerably tightened relative to the New York Annex.	See comment in relation to the Provisions.

Business days	The definition of "Margin Business Day" in the Provisions is basically the same as the definition of "Local Business Day" in the New York Annex, except that, in relation to a transfer of securities, one also takes into account whether the intermediary holding the transferee's account is open for business.	See comment in relation to the Provisions. "Local Business Day" in the New York Annex is defined by reference to the definition of this term in Section 14 of the ISDA Master Agreement.
Base Currency and Eligible Currency	The Provisions contemplate the possibility of exposure and margin assets in different currencies, and both provide that all such amounts will be converted to an agreed Base Currency for purposes of determining margin requirements. Margin deliveries, however, may be made in any Eligible Currency.	The New York Annex assumes that exposure and all margin assets will be denominated in U.S. Dollars. There is therefore no currency conversion mechanism.
Other Eligible Support	The Provisions do not contemplate the use of the Supplement together with other forms of non-margin credit support, such as guarantees and letters of credit.	The New York Annex includes the necessary mechanics to permit a guarantee, letter of credit or other non-margin form of credit support given to the Secured Party to be taken into account when determining Delivery Amounts and Return Amounts.
Use of margin assets by the margin taker	The Provisions, regardless of which governing law and legal approach are chosen, permit the margin taker to use the margin assets for any purpose, including resale, repo, re-pledge or other disposition. Under the title transfer approach, this is, of course, because the margin taker becomes the owner of margin delivered to it.	The New York Annex permits the margin taker to use the margin assets for any purpose, including resale, repo, re-pledge or other disposition.

APPENDIX H

TABLE COMPARING KEY ELEMENTS OF THE PROVISIONS WITH THE ENGLISH ANNEX

***Note**: This table (which is not exhaustive) is intended for general guidance only, to highlight the principal substantive similarities and differences between the Provisions and the English Annex. For a summary of the principal similarities and differences in terminology, see Appendix F.*

One general difference highlighted above in this Guide is the fact that the Provisions may be used to collateralise exposures under a non-ISDA Agreement and under more than one (ISDA and/or non-ISDA) Agreement, whereas the English Annex is designed for use only with an ISDA Master Agreement. This table, for simplicity and clarity, assumes use of each document only with an ISDA Master Agreement.

	The Provisions	**The English Annex**
Architecture of the document when used with an ISDA Master Agreement	The Provisions are incorporated by reference into a form of Supplement, which is annexed to the related ISDA Master Agreement. The Supplement sets out the elections and variables of the parties, including the choice of governing law and legal basis, as well as any modifications to the Provisions.	The English Annex is annexed to the related ISDA Master Agreement. Paragraph 11 to the English Annex sets out the elections and variables of the parties as well as any modifications to the other provisions of the English Annex.
Governing law and legal basis	The Provisions provide a choice of governing laws, as outlined in the text of this Guide. The choice of the English law title transfer approach in Part 3 of the Provisions to govern a Supplement incorporating the Provisions creates a document equivalent to the English Annex. The key technical difference between the Provisions and the English Annex in this regard is that the Provisions rely expressly on contractual set-off, whereas the English Annex relies on the close-out mechanics of Section 6(e).	The English Annex is based on title transfer. The application of English law is assumed, based on the choice made by the parties in Part 4 of the Schedule to the ISDA Master Agreement. There is no separate governing law clause in the English Annex. The English Annex is deemed to be a Transaction for purposes of the related Master Agreement. This is essentially for mechanical reasons, so that the Credit Support Balance (the amount of margin held by the margin taker) may be deemed an Unpaid Amount for purposes of the Section 6(e) close-out calculations.
Calculation of Delivery Amounts and Return Amounts	The calculation of Delivery Amounts and Return Amounts is essentially the same in both documents.	
Lock-up Margin	The Provisions provide for initial margin in the form of the Lock-up Margin. Lock-up Margin is determined separately from Delivery Amounts and Return Amounts and may not be off-set against those amounts or any other amount of Lock-up Margin or Margin Received. Lock-Up Margin may be due from a Provider even when the Taker has no Exposure, and each party may hold Lock-up Margin from the other party at the same time.	There is no concept in the English Annex equivalent to Lock-up Margin.

Transfer timing	See Appendix C. Essentially, transfer timing is intended to be tighter under the Provisions than it is under the English Annex.	Transfers must be complete by the close of business on the relevant Settlement Day. The Settlement Day for a transfer of cash is the next Local Business Day after the relevant demand for transfer. The Settlement Day for a transfers of securities is the first Local Business Day after the relevant demand for transfer on which settlement of that type of security would customarily occur in the agreed clearance system or on the market where those securities are principally traded.
Valuation of margin	Cash is valued at its face value less any applicable "haircut" (by multiplying the cash amount by any specified Valuation Percentage). Securities are valued at the bid price obtained by the determining party <u>plus accrued income</u> less any applicable "haircut".	Valuation of cash and securities is essentially the same in the English Annex as in the Provisions, except that in the English Annex accrued income is not expressly included (although it may already be reflected in the relevant bid price).
Valuation of exposure	The valuation of Exposure is essentially the same in both documents.	
Who determines valuations	Valuations of Delivery Amounts and Return Amounts are made by the Calling Party. Valuation of Equivalent Distributions and Interest Amounts are made by the relevant Taker.	The Valuation Agent, which may be specified in Paragraph 11. In practice, this would be the calling party in relation to Delivery Amounts and Return Amounts and the Transferee in relation to Equivalent Distributions and Interest Amounts. So in practice the two documents would work the same in this regard.
Dispute resolution	See Appendices D.1 and D.2. The dispute resolution procedure in the Provisions is intended to be more rigorous and allow less flexibility for delaying tactics than under the English Annex. The principal sanction for delay is that the delaying party is deemed to agree with the determination of the other party. Also the procedure for disputes regarding the amount of margin to be delivered is distinguished from the procedure for disputes regarding the value of margin that was delivered.	Although set out as a single procedure, the dispute resolution provisions of the English Annex distinguish between disputes regarding margin calls and disputes regarding the value of margin delivered. The procedure in the English Annex proceeds along a more relaxed timeframe than in the Provisions, and there are no specific sanctions if those timeframes are not respected.
Substitutions/exchanges	See Appendix E. The key difference between the Provisions and the English Annex in this regard is that the timing of transfers in connection with a substitution has been considerably tightened relative to the English Annex.	See comment in relation to the Provisions.

Business days	The definition of "Margin Business Day" in the Provisions is basically the same as the definition of "Local Business Day" in the English Annex, except that, in relation to a transfer of securities, one also takes into account whether the intermediary holding the transferee's account is open for business.	See comment in relation to the Provisions.
Base Currency and Eligible Currency	Both the Provisions and the English Annex contemplate the possibility of exposure and margin assets in different currencies, and both provide that all such amounts will be converted to an agreed Base Currency for purposes of determining margin requirements. Margin deliveries, however, may be made in any Eligible Currency.	
Other Eligible Support	The Provisions do not contemplate the use of the Supplement together with other forms of non-margin credit support, such as guarantees and letters of credit.	Unlike the New York Annex, the English Annex does not contemplate the use of the Supplement together with other forms of non-margin credit support, such as guarantees and letters of credit.
Use of margin assets by the margin taker	The Provisions, regardless of which governing law and legal approach are chosen, permit the margin taker to use the margin assets for any purpose, including resale, repo, re-pledge or other disposition. Under the title transfer approach, this is, of course, because the margin taker becomes the owner of margin delivered to it.	Because the margin taker under the English Annex becomes the owner of margin delivered to it, it is, of course, able to use those assets as it sees fit, including for purposes of resale, repo, pledge or other disposition.