

NAFMII Master Agreement

Chinese standards brought to OTC Derivatives

Alban Caillemer du Ferrage

Partner

Gide Loyrette Nouel

Global Derivatives Group

European Union Chamber of Commerce

Swiss Chinese Chamber of Commerce

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Gide Loyrette Nouel

PLAN

- General
- Architecture
- « Three pillars » standard OTC derivatives documentation
- Comparison with ISDA international market master agreements
- Transactional scope of application and related issues - intention v/ potential?

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This presentation does not constitute legal advice and should not be used as the basis for giving advice or transacting without prior checking the primary sources.

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Gide Loyrette Nouel in China

Global Derivatives group: local knowledge with international capability

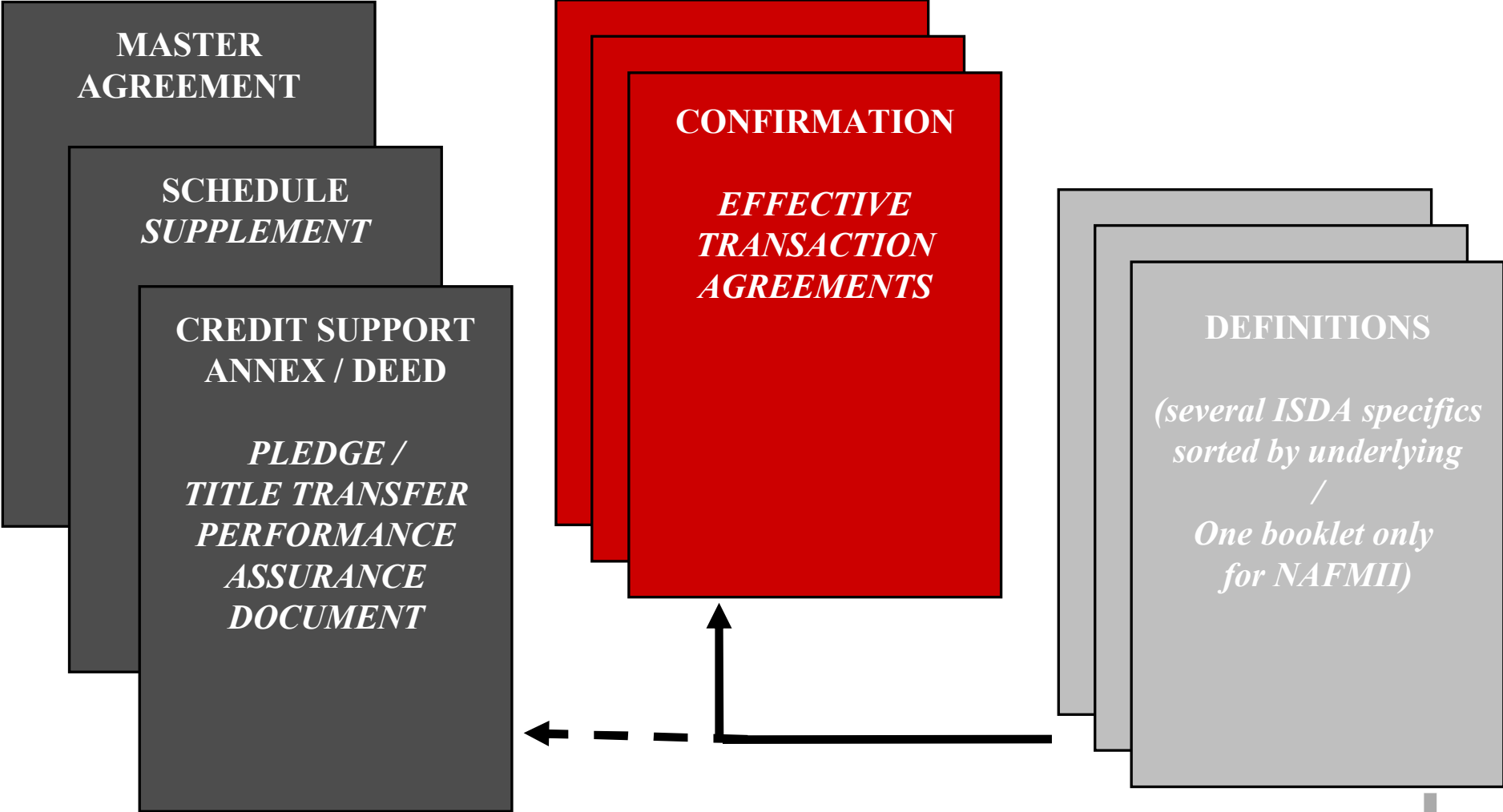
- Founded in Paris in 1920, operates from 24 offices in 19 countries
- Present in China (**Beijing / Shanghai / Hong Kong**) for more than 15 years, among the first foreign law firms to be granted a license from the Chinese Ministry of Justice
- In China, more than 130 people, including 70 western and Chinese lawyers, 3 offices in Beijing, Shanghai and Hong Kong
- Derivatives Structured Finance group co-led by
 - Alban Caillemer du Ferrage (Paris)
 - Colin Mercer (London)
 - Balbir Bindra (Hong Kong)
 - Robert MacDonald (New York)
- French legal advisor to ISDA since 1985
- One of the largest team on the market fully dedicated to the servicing of the institutional clients of the Firm for structuring, regulatory and documentation issues re OTC derivatives and structured products



GENERAL

- 1st version in 2007 (RMB Transactions)
- New version in 2009 after being merged with CFETS Agreement (RMB-FX trades)
- Main features
 - Governed by Chinese law
 - Subject to Chinese courts' jurisdiction or Chinese arbitration
 - Two collateral documents
 - Pledge Performance Assurance Document
 - Title Transfer Performance Assurance Document
 - Definitions Document
 - Basic definitions
 - Specific definitions for interest rate, bond, currency and credit derivatives

ARCHITECTURE

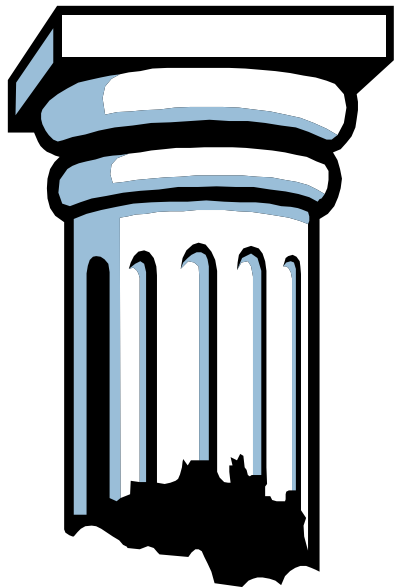


The « Agreement »

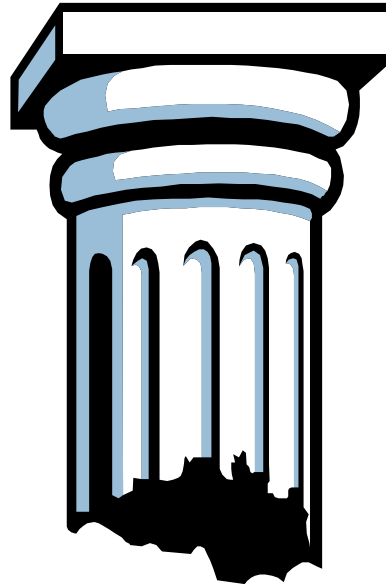


THREE PILLARS

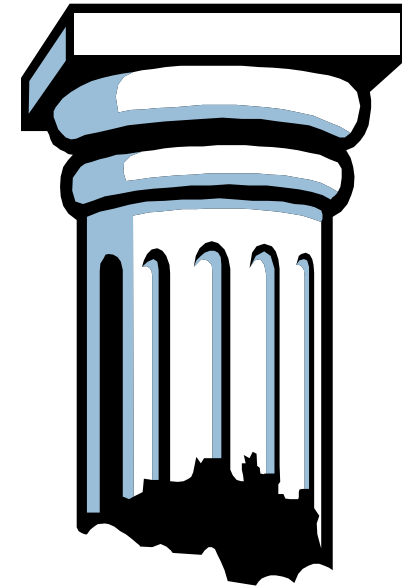
No. 1: Single Agreement



SINGLE AGREEMENT



FLAWED ASSET



CLOSE-OUT NETTING

Section 1(c) of the ISDA Master Agreement

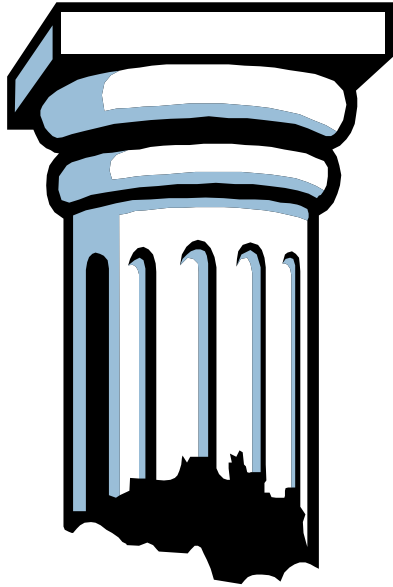
(c) *Single Agreement.* All Transactions are entered into in reliance on the fact that *this Master Agreement and all Confirmations form a single agreement* between the parties (collectively referred to as this "Agreement"), and the parties would not otherwise enter into any Transactions.

Section 1(I) of the NAFMII Master Agreement

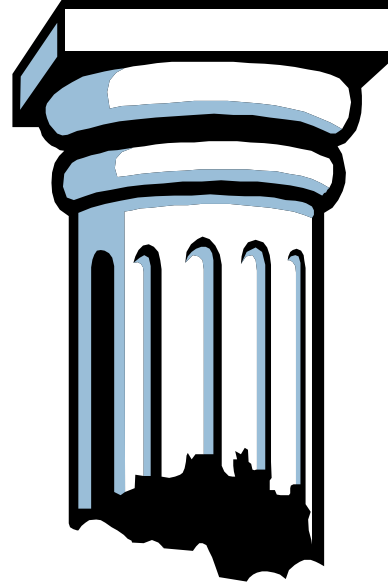
the Master Agreement, the Supplement and the Effective Transaction Agreements *constitute a single and complete agreement* between the Parties.

THREE PILLARS

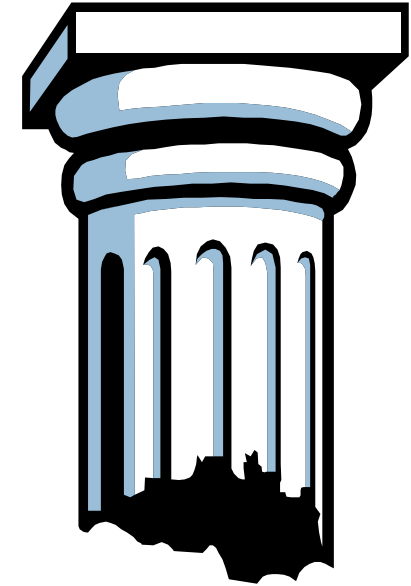
No. 2: Flawed asset



SINGLE AGREEMENT



FLAWED ASSET



CLOSE-OUT NETTING

Section 2(a)(iii) of the ISDA Master Agreement (Obligations - General Conditions)

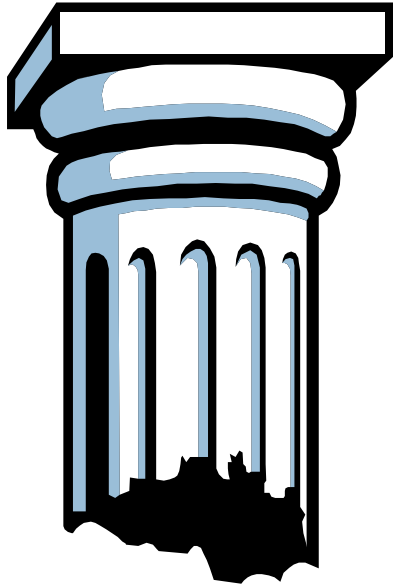
(iii) Each obligation of each party under Section 2(a)(i) is subject to (1) the condition precedent that **no Event of Default or Potential Event of Default** with respect to the other party has occurred and is continuing, (2) the condition precedent that **no Early Termination Date** in respect of the relevant Transaction has occurred or been effectively designated and (3) **each other applicable condition precedent** specified in this Agreement.

Section 4(III) of the NAFMII Master Agreement

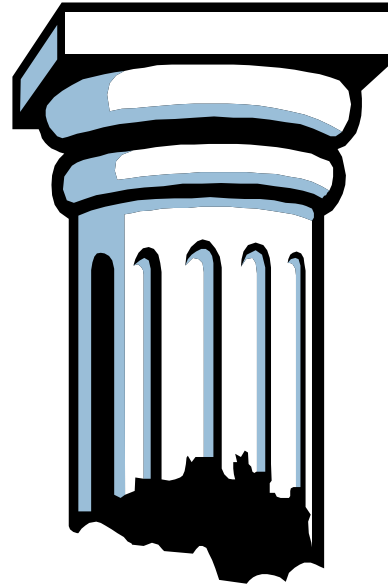
A Party's performance of its payment or delivery obligations in accordance with the terms of the Effective Transaction Agreement shall be subject to the satisfaction of the following conditions precedent: 1) **No Event of Default or Potential Event of Default** with respect to the other party has occurred and is continuing; 2) with respect to a Transaction resulting in such payment or delivery obligation, **no Early Termination Date** has occurred; 3) **any other conditions precedent** as may be agreed by the Parties

THREE PILLARS

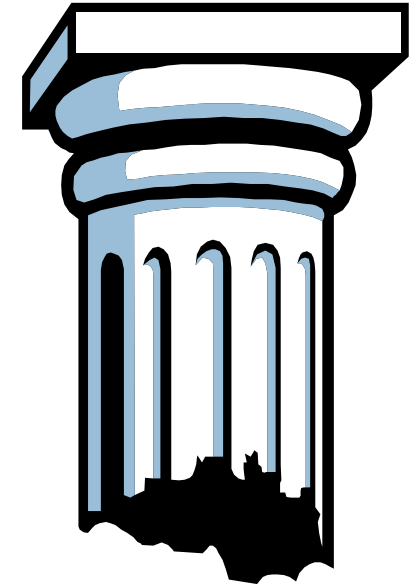
No. 3: Close-out netting



SINGLE AGREEMENT



FLAWED ASSET



CLOSE-OUT NETTING



Section 6 of the ISDA Master Agreement (Early Termination)

(a) Right to Terminate Following Event of Default. [...] / (b) Right to Terminate Following Termination Event. [...]

Sections 9 (Handling of Events of Default) and 10 (Handling of Termination Events)

9(I)(1) Determination of Early Termination Date

10(III) Determination of Early Termination Date



ISDA / NAFMII COMPARISON

Payment netting / Close-out netting / Set off

	description	ISDA	NAFMII
<i>Payment netting</i>	In respect of the same Transaction, several or even all them, payment netting between amounts payable by one or the other Party on the same date in the same currency	Section 2 (c)	Sections 4(IV) and (V)
<i>Close-out netting</i>	Termination of the outstanding Transactions, calculation of the market value of the Termination Transactions and calculation of the unique netted early termination amount	Section 6 (e)	Sections 9 and 10
<i>Set off</i>	Post - <i>close-out netting</i> , the Non-defaulting party has the right to set off the early termination amount payable by one party against any other amounts payable by the other Party to such Party	Section 6 (f)	Section 13

ISDA / NAFMII COMPARISON

- Nothing (or almost nothing) about the **Transactions**...
 - Section 4(I) of the NAFMII Master Agreement: *Subject to other provisions of this Agreement, if a Party has an obligation to make a payment to the other Party under a Transaction, the payment shall be made by such Party to the other Party in accordance with terms in relation time, place, currency, amount, account and payment method as may be agreed between the Parties; the delivery shall be made on the agreed date in accordance with customary industry practices*
 - Section 2(a)(i) of the ISDA Master Agreement : *Each party will make each payment or delivery specified in each Confirmation to be made by it, subject to the other provisions of this Agreement*

ISDA / NAFMII COMPARISON

- ... but everything about **the relationships** between the Parties

	ISDA	NAFMII
"sunny side"	<ul style="list-style-type: none"> ▪ Interpretation ▪ Obligations ▪ Representations ▪ Agreements 	<ul style="list-style-type: none"> ▪ Formation and Hierarchy ▪ Application of the Master Agreement ▪ Representations and Warranties ▪ Performance of Payment of Delivery Obligations ▪ Performance Assurance
"dark side"	<ul style="list-style-type: none"> ▪ Events of Default and Termination Events ▪ Early Termination 	<ul style="list-style-type: none"> ▪ Events of Default and Termination Events ▪ Handling of Events of Defaults and handling of Termination Events
"back side"	<ul style="list-style-type: none"> ▪ Transfer ▪ Contractual Currency ▪ Miscellaneous ▪ Offices; Multibranch Parties ▪ Expenses ▪ Notices ▪ Governing Law and Jurisdiction ▪ Definitions 	<ul style="list-style-type: none"> ▪ Telephone recording ▪ Confidentiality and Information Disclosure ▪ Dispute Resolution ▪ Method and Effectiveness of Notices ▪ Expenses ▪ Remedies ▪ Amendment ▪ Execution
"far side"	Bridges	

ISDA / NAFMII COMPARISON

Close-out (1/2)

- Termination trigger events
 - Events of Default
 - Failure to Pay or Deliver
 - Breach of Agreement; Repudiation
 - Credit Support Default / Performance Assurance Provider Default
 - Misrepresentation
 - Default under Specified Transaction
 - Cross Default
 - Bankruptcy
 - Merger without Assumption
 - Termination Events
 - Illegality
 - Credit Event Upon Merger
 - Force Majeure
 - Tax Event / Tax Event Upon Merger

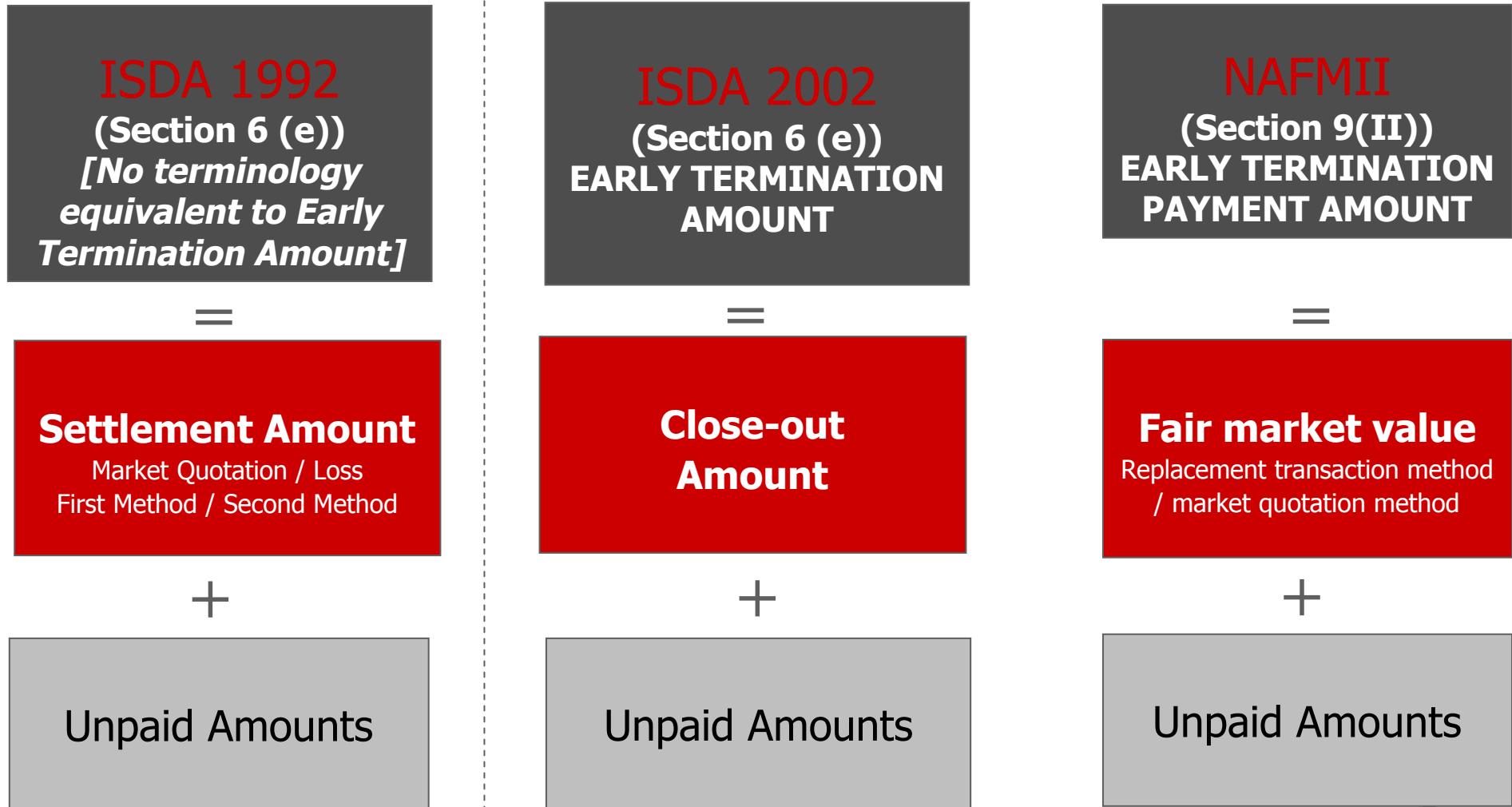
ISDA / NAFMII COMPARISON

Close-out (2/2)

- Close-out
 - Who ?
 - Events of Default : Non-defaulting Party (Bankruptcy – possibility of Automatic Early Termination)
 - Termination Events
 - Illegality or Force Majeure : either party
 - *Credit Event Upon Merger* : Non-affected Party
 - What ?
 - Events of Defaults: all outstanding Transactions
 - Termination Events : Affected Transactions, except for Credit Event Upon Merger, all outstanding Transactions
- Valuation
 - ISDA: Market Quotation / Loss (1992); Close-out Amount (2002)
 - NAFMII: Replacement transaction method / Market quotation method
- Determination of settlement amount
 - ISDA: Two-way payment / Walkaway clause
 - NAFMII: two-way payment

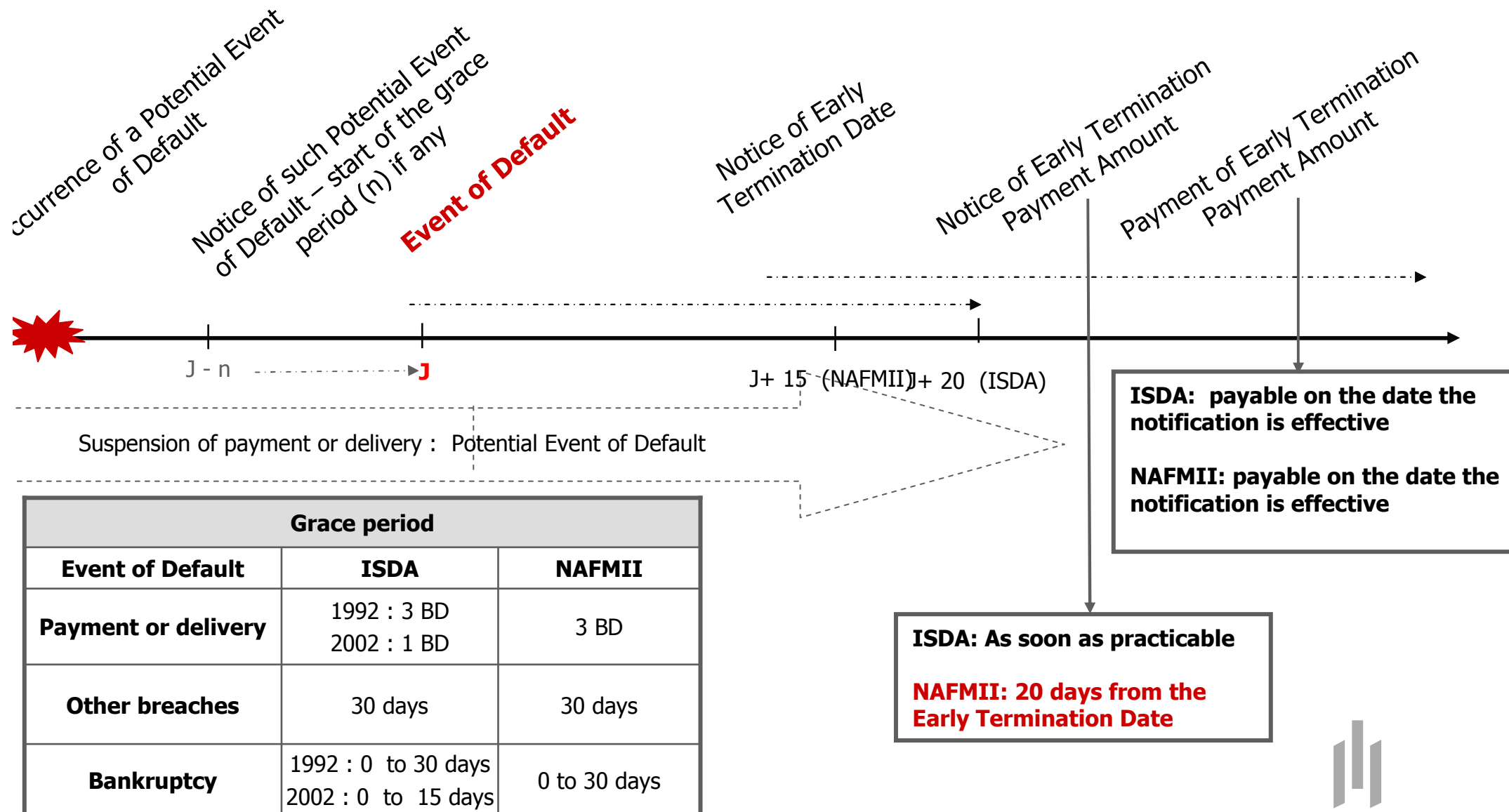
ISDA / NAFMII COMPARISON

Composition of the early termination amount



ISDA / NAFMII COMPARISON

Procedure to follow in case of an Event of Default



ISDA / NAFMII COMPARISON

Main differences

- NAFMII definition of Financial Derivatives Transactions
 - financial derivative agreements entered into between Parties governed by the Master Agreement [2009 NAFMII] as required by law **AND** any other financial agreements as agreed by Parties to be governed by it, including but not limited to interest rate, currency, bond, credit, gold derivative transactions and any combination of such transactions
- Single branch approach
- **Single jurisdiction approach**
 - Insolvency definition more tailored to Chinese law
 - No tax representations
 - No tax related termination events
 - No tax covenants or delivery of tax documents
- No Loss - Early Termination Payment Amount calculated pursuant to either:
 - A method similar to the Close-out Amount definition, or
 - A method similar to Market Quotation with a fall back to Close-out Amount

SCOPE & RELATED ISSUES

- Intended scope
 - Broad definition of Financial Derivatives Transactions by NAFMII
 - Parties are prevented from changing such scope
 - PBOC Announcement of March 11, 2009: NAFMII mandatory use for onshore derivatives transactions between « interbank market participants »
 - But no statutory definition of « interbank market participants »
 - But doubts as to whether equity or commodity transactions are covered by PBOC rule

SCOPE & RELATED ISSUES

- Potential issue: application of PBOC rule may create conflict between several master agreements entered into between the same two counterparties, e.g. with an ISDA Master Agreement entered into:
 - by interbank market participants
 - For their cross border transactions
 - For their onshore transactions not required by PBOC to be governed by NAFMII
 - by other counterparties for any of their trades (universal contractual scope of NAFMII)
- Effects of potential conflict of master agreements
 - Loss of the single agreement pillar
 - Increased credit risk in insolvency situations (flawed asset)
 - Increased systemic risk
- Possible outcome ?

SPEAKER'S CONTACT

Alban Caillemer du Ferrage

Avocat à la Cour, Partner

Member of the Market Commission of the Financial Market Authority

Mail: acf@gide.com

DL: +331 40 75 36 50

Mob: +336 72 73 07 88

Fax: +331 40 75 37 86

www.gide.com



Gide Loyrette Nouel

Gide Loyrette Nouel in Beijing

Suite 3501 - Jing Guang Centre
Hu Jia Lou, Chaoyang District
Beijing 100020
People's Republic of China

Tel. : +86.10.65.97.45.11

Fax : +86.10.65.97.45.51

Gide Loyrette Nouel in Paris

26, cours Albert 1er
75008 Paris
France

Tel.: +33.1.40.75.60.00

Fax.: +33.1.40.74.02.74

Gide Loyrette Nouel in Hong Kong

Suites 1517-19 Jardine House
1 Connaught Place
Central, Hong Kong

Tel.: +852.25.36.91.10

Fax.: +852.25.36.99.10

Gide Loyrette Nouel in London

125 Old Broad Street
London EC2N 1AR
UK

Tel.: +44 (0)20 7382 5500

Fax: +44 (0)20 7382 5501



Gide Loyrette Nouel

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