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DERIVATIVES market in Italy.
Main tools: ISDA Master Agreement and GMRA Master agreement

The main tools of DERIVATIVES market in Italy are entering into and executing an ISDA Master Agreement (and the Confirmations under such Master Agreement, the "ISDA agreement") and a GMRA Master agreement (the "GMRA agreement") and to perform its obligations under such agreements.

This note will be over the two species of contractual netting agreement and about:

- The law governing the netting agreements and their transactions (and/or confirmations) and
- The netting arrangements and the law of the jurisdiction.

1. Incorporation, corporate power, capacity and authorization of an Italian company

In connection with the capacity and authorization of an Italian company to enter into ISDA or GMRA master agreements, a lawyer must check and control the copies of the accessible and public records of the company, the Registration Statement, the Company Statute, the Company bylaws with respect to the prospective negotiation of any Master netting agreement.

This examination of this documentation is directed to verify

- the power, comprised in the Company object, of an Italian company to deal in derivative transactions and securities,
- the powers of signing in the confirmations of every transactions, particularly with regard to verifying how powers of management are consistent with the nature of society and its "governance",
- the credentials of representatives and/or agency power, and
- the abstract validity of specimens of signature (and of eventual so-called "electronic signatures").

1.1 Legal and Company's bylaws Limits with regard to power of entering into the agreements

Subject to the foregoing and on the basis of the aforementioned examinations and investigations, the law of the place (Italy) where the investor operates will apply to ISDA and GMRA agreements, namely Italian law, due to ordinary application of rules of Italian private international law, unless a different choice of the parties is expressed in the contract.

This way, a first problem arises: Italian legal mandatory rules can interfere with the execution of the ISDA and GMRA agreements, setting to them any limits, or the bylaws of the involved company will do the same.

Particularly, a first legal limit concerns the legal entities which cannot enter into contracts in Italy relating to derivatives. In fact, not all legal entities can nowadays enter into derivative contracts, as financial investors, due to the mandatory rule that forbids it to "the Regions, the Autonomous Provinces of Trento and Bolzano and local public bodies" (Article 62, paragraph 2° of Decree of 25 June 2008, no. 112, converted in Law 6 August 2008, no. 133, introduced by Article 3 Law 22 December 2008, no. 203, so called Finance Act 2009). However an Italian company has not nature of local or national public body, even if it is capitalized and supervised by the State, so that such a limit does not work for the same.

Italian case law (Italian jurisprudence) has also raised the question whether all legal persons, including companies, can effectively enter into any derivative contract in the role of investors, noting that a possible "subjective" limit can come from the mandatory legal rule which forbids derivatives business, or about securities, if this is inconsistent with the company object (see Tribunal of Bergamo: its judgment of 4 May 2006 ruled that was invalid a derivative contract, "because purely speculative, on the basis of lack of instrumentality of this initiative with regard to pursuits of the company").

2. Italian Legal qualification and relation with stock exchange regime.

The ISDA and GMRA are construed under Italian law of financial contracts, through normative reception of MiFID Directive of 2004, which led to the introduction into the TUF n. 58 ("Testo Unico di Finanza", Consolidated Text of Finance, Legislative Decree no. 58/1998) of new rules for classifying bilateral framework-agreements (Master Agreements) relating to derivatives, traded over the counter (OTC).

2.1 Uniqueness of the contract and means of communications

The ISDA scheme of contract is a master agreement, which manages various confirmations of individual swap transactions or of other derivatives related to a notional, which is qualified, also in Italy, as a unique contract together with the confirmations, and is considered lawful because, according to Italian Jurisprudence, art. 1933 of the Civil Code ("C.C."), prohibiting purely aleatory contracts and not protecting them, shall not be applied. Thus, strictly speaking, the ISDA and related transactions represent a unique contractual tool that consists of the components of the Master Agreement, the Schedule, the Confirmations, the Definitions and the Credit Support Document (the latter governs the collateral, namely the collateral contract that guarantees, in case of default of either party at respective term, to pay the other a certain amount of money or of securities), and of the operative correlations between the content of ISDA Master Agreement and the content of each ISDA Confirmation (particularly, the clause of Calculation Agent, the clause which sets forth the exchange of confirmations in electronic format, the clause which excludes the application of the so-called "Collateral" for certain specific transactions). Also

in Italy, the collateral can be sold or used ad interim by the beneficiary. Finally, communications of the confirmations are valid in Italy whether via phone or via electronic means.

The GMRA scheme of contract is a standard master agreement for REPO transactions, which also in Italy can be qualified as a netting agreement. The "Repo" transactions are sale and repurchase agreement of securities, where a sale happens together with an agreement for the seller to buy back the securities at a later date. The repurchase price should be greater than the original sale price, the difference effectively representing interest, sometimes called the REPO rate. The party that originally buys the securities effectively acts as a lender. The original seller is effectively acting as a borrower, using the security as collateral for a secured cash loan at a fixed rate of interest. Therefore, a REPO is equivalent to a spot sale combined with a forward contract, where the difference between the forward price and the spot price is effectively the interest on the loan, while the settlement date of the forward contract is the maturity date of the loan. A serie of "REPOs" generally requires a master agreement to be in place between the buyer and seller (typically terms standardized by the SIFMA/ICMA organizations). Finally, the GMRA is a master agreement, qualified in Italy as a bilateral netting agreement (netting agreement), and related transactions represent, together with GMRA, a unique contractual tool that consists of the Master Agreement, the Form of Confirmation (of each transactions) and the Special Conditions. Communications of the confirmations are valid in Italy whether via phone or via electronic means.

2.2 Italian Legal Compliance of a foreign Bank at the regard of ISDA and GMRA agreements

A foreign bank, offering a derivatives deal, can be compared, according to Italian TUF, to an EU investment firm (if the bank is European), which can execute financial activities in Italy, subject to mutual recognition (in the territory of foreign country) without any need of establishing branches, provided that the Bank of Italy and CONSOB have been informed by the competent authority of its State of origin. The regime of operations recognized in Italy to such EU investment firm is qualified "free services provision regime" (further, CONSOB, Italian stock exchange authority, should also register such EU investment firms in a specific list, annexed to registry of extra-EU enterprises prescribed by art. 20 TUF).

Further, contracts (ISDA and GMRA) providing investment services and their accessories shall be in writing and a copy consigned to the client (Art. 23 TUF). On the other hand, the assets of the client, resulting from the execution of such investment services and accessories, the financial instruments and the amount of money of every client, for any reason held by the investment entity (Bank), shall be deemed as distinct in all respects from that of the European Bank; on this assets, in accordance with articles 22 and 91 of TUB ("Testo Unico di Banca", Italian Banking law), no actions will be allowed to creditors of the intermediary or in the interest of the same, nor to those creditors of eventual custodian or sub-custodian or in the interest of the same.

2.3 Relation of ISDA and GMRA agreements with Official Exchange Regulations

Compared to stock exchange regulations, the ISDA and GMRA and related confirmations and/or transactions are qualified as operations that are not traded in the exchange, but outside such regulated market (namely, over the counter, "OTC"), and fall within the legal definition of Italian "unregulated markets".

However, despite being an unregulated market these contractual schemes do not even assume the form of two typed Italian "unregulated markets", such as 1) "MTFs" (Multilateral Trading Facility) and 2) Systematic Internalisers, namely the two ordinary qualifications that Italian law assigns to non-regulated markets. In fact, ISDA and GMRA differ from the first (Multilateral Trading Facility), because they do not relate to multilateral operations (with multiple parts), and from the second (Systematic Internalisers), because the Bank is part of the contracts, differently from the internaliser, which is a bank that organizes trading without being party to the contract. Anyway, like all non-regulated market, for ISDA, GMRA and related confirmations there are no "reporting" requirements on the trade or mandatory access to a channel of public disclosure of transactions (which transactions can all remain confidential). At the same time, ISDA and GMRA are fully permitted under Italian civil law, as an expression of business private autonomy, as well as for purely speculative aims, given for granted the jurisprudential disapplication of art. 1933 C.C. (which in the recent past did not grant legal action or legal protection to purely aleatory contracts or of mere bet, even if legally permitted).

Finally, in Italy, such contracts will have no centralized clearing and settlement services, but all services will depend on private autonomy. There is not, in Italy, a set of transparency requirements in pre- and post-trading of ISDA and GMRA. The contracts will be negotiated, and will simply have confirmations, under the regime of Over The Counter (OTC), inside a private market in which trading will take place (outside the official stock exchange circuits), with characteristics of non-standardized contracts, with informal quotations either through bilateral talks between the parties (direct supply and demand) and through telephonic or electronic means (according to the principle of direct matching between supply and demand), and without necessary relation with the trend of stock exchanges worldwide.

Other features allowed in Italy, according to Italian law, are the following:

- There is no requirement of "market making" in respect of intermediaries/negotiators;
- There is no "book" of negotiation in which are automatically collected and matched purchase orders and sales;
- There are no controls at the level of trading;
- There are no information duties for issuers of securities.

However, the recently amended TUF and the new EU regulation "EMIR", entered into force in November 2012, made to above mentioned characteristics the following exceptions.

- With regard to master agreements relating to OTC markets based in Italy, CONSOB may request the organizers, issuers and operators to furnish data, information and documents, if and when the derivatives trade is organized for the public, through a network of branches (Articles 78 and 79 TUF, Legislative Decree no. 58/1998), that is, through the so-called SSO trading system ("sistema di scambi organizzati"); in this case CONSOB shall maintain a list of organized SSO trading systems. Of course, this exception does not apply to the bilateral

relationship Foreign Bank-Italian company nor it implies any control toward these two subjects, particularly because these parts are non homogeneous (a Bank and a commercial Company).

- The EMIR European Regulation 648/2012, in force in Italy since November 1, 2012 (incorporated also by so-called "Decreto Sviluppo", Development Decree) makes obligatory, on both traditional markets and on those over-the-counter, communicating all standardized contracts to so-called repositories of data on trading (*trade repositories*), held in Italy by CONSOB and by the BANK OF ITALY (Italian Central Bank), and places the obligation to notify these competent national authorities the individual net short positions in officially Italian listed shares and State bonds; in addition there is the obligation to compensate the negotiations through central counterparts (in Italy, the "Bank of Italy", as the entity authorized to guarantee the execution, interposing itself between the two involved parties) both for short sales and for CDS (credit default swaps, namely the derivatives which insure form the risk of default of other securities);

In this respect, Italian system reception of the regulation have had no significant effects for the Italian OTC market of bilateral Master Agreements (netting agreement) with one of the party of non-financial nature and another even foreign, as the exampled European Bank, especially if such OTC market is governed by the ISDA master agreement or by GMRA. Particularly, the EMIR Regulation places obligations concerning standardized OTC contracts, and not strongly atypical contracts like the above mentioned master agreements; besides, these obligations will come into force when is attained the threshold of 0.2% of the share capital of the issuer or of a certain equivalent amount of government bonds, while, incidentally, they will never apply to primary dealers of government bonds, sovereign CDS and market makers (provided prior notification of this exemption to the competent supervisory authority). EMIR Regulation, of course, prohibits short "naked" selling on government bonds (namely, without the availability of the securities), and speculative positions on CDS related to sovereign issuers, **but conclusively, financial operators, who will continue to conclude OTC contracts on a bilateral basis, using ISDA and GMRA master agreements that do not meet the requirements of high standardization and of the clearing by a clearing house, will only have to meet adequate capital requirements (eventually more stringent of the past). At the moment, EMIR seems to oblige, directly, to a clearing official service only contractual parties of derivatives of "plain vanilla IRS" type.**

3. Choice of law of the contract, choice of jurisdiction and Italian mandatory rules

Subject to the foregoing and on the basis of the aforementioned examinations and investigations, in absence of a clear and explicit choice of law and jurisdiction in the contract (ISDA and GMRA), the law of the place where the investor (if Italian) operates will apply (Italian law), and will be applicable the Italian venue as for jurisdiction, due to Italian private international law and due to Brussels conventional regime of jurisdiction (so called Brussels I Regulation, applicable to both ISDA and GMRA agreements). Anyway, it shall be repeated: the parties could choose a different law and venue, subject to provisions of system of Rome Convention of 1980 (today absorbed by the EU Regulation n. 593/2008 of 17 June 2008).

About the law of the contract, in absence of a clear and explicit choice of law and jurisdiction in the contract (ISDA and GMRA), the Italian law and Jurisdiction will apply due to place of execution rule (Italy) and to general limits regime of inalienable rights as jointly provided by articles 4, 14 and 57 of Law no. 218/95. Article 57, particularly, recalls art. 8 of Rome Convention of 1980 (on the law applicable to international contracts, today replaced by art. 10 of new Convention included in Regulation no. 593/2008 of 17 June 2008, replacing entire earlier Convention of 1980). While, par. 2° of art. 4 of the. n. 218/95 forbids the derogation of Italian jurisdiction where the dispute relates to so called inalienable rights: And inalienable rights could really exist in the case of an Italian company, where Italian State can have a potential interest to the destiny of financial balance of a great Italian company, especially if this company is funded by citizens state taxation and is participated by the State, so that any disputes about ISDA and GMRA might affect public money (and related State inalienable rights to this), and making attract the related issues to Italian law and jurisdiction.

Recently, the United Sections of Supreme Court ("SSUU Cassazione Civile", ord. no. 3841/07) have, however, established exactly at the regard of an ISDA master agreement, that a clause of express and clear derogation of the jurisdiction in favour of the foreign court (English in the given case) is valid, so confirming the application of article 23 of the EC Regulation 44/2001 of 22 December 2000, which expressly defines as exclusive the jurisdiction conventionally attributed by the parties to the court of a Member State, on the same line of art. 13 of the ISDA model. Much the same can therefore be said for the GMRA agreement, art. 17, which identifies the English law and venue.

3.1 Choice of law and Regime of Weaker party

The choice of Anglo-Saxon venue is sometimes preferred by foreign banks, to ensure that, in accordance with art. 31 of CONSOB Regulation, the legal representative of Italian company does not make use of the protection of the weaker Italian non-professional party. Precisely, if at the time of signature of the GMRA or ISDA the legal representative does not explicitly state, according to art. 31 Reg. CONSOB, that the company is a qualified operator, which actually has those skills and qualities to deal with securities and derivatives, then, the Italian company might invoke the protection of the weaker party, unprofessional and non-expert in derivatives. Possibility that is excluded from the British and American legal systems, while the stipulation according to Italian law by the weaker party could result in the nullity of the swap agreements, for lack of cause, given that consumers or weaker parties cannot enter into the swap agreement, which are atypical and aleatory, so lacking of clear "concrete reason for the contract."

3.2 Italian mandatory rules

In all cases where happen the choice of a different law the ISDA and GMRA should comply with the requirements of the Bank of Italy Circular no. 263 of 27 December 2006 ("New regulations for the prudential supervision of banks"), which contains some mandatory provisions. In fact, the circular allows the mitigation of credit risk (credit risk mitigation - CRM) as provided by the contractual mechanism of ISDA and GMRA and, in general, by netting agreements, due to reception from 1st January 2008 of EU Directives n. 2006/48 and 2006/49 (Capital Requirements Directive - CRD), which represents the new prudential regulations for banks and banking

groups "Basel 2" and is based on so-called three "pillars". An Italian company is certainly not a bank, but its corporate bodies must comply with these rules, because the conclusion of bilateral netting agreements regards an European Bank.

According to such Circular the Credit protection associated to master netting agreements (ISDA and GMRA), is of real type, and there are some general requirements, aimed at ensuring legal certainty and effectiveness of the guarantees, which relate to

- the binding nature of legal commitment between the parties and its enforceability in court,
- the documentability,
- the enforceability of the instrument toward third parties, in all jurisdictions relevant to the enforcement;
- the timeliness of enforceability in the event of default.

The same Circular prescribes for the above GMRA and ISDA, as special conditions of effectiveness in Italy, that the master agreements:

a) are effective and enforceable in all relevant jurisdictions, including in the event of insolvency or bankruptcy and procedures similar to bankruptcy of the counterpart;

b) ensure to the non-defaulting party the right to terminate and timely close all transactions under the agreement upon the event of default, including the case of insolvency or bankruptcy or procedures similar to bankruptcy of the counterpart;

c) provide for compensation, or other equivalent effect, of the respective debit and credit positions, related to transactions closed-out under the framework agreement, so that only a single net amount is owed by one party to another (close-out netting clause).

4. Netting Opinion and enforcement of foreign judgment in Italy

These conditions, especially the compensation through close-out netting clause, can be considered - in general and unless specific assessments are required time after time - effective and binding in Italy, certainly in the case of termination events (such as supervening impossibility, hardship and contrariety to mandatory rules), but also in cases of bankruptcy, liquidation and restructuring procedures (so called events of default), which may affect an Italian company, due to reform of article 203 TUF, which has extended to such general category of contracts on securities or on derivatives (including also ISDA and GMRA) the application of Art. 76 LF ("Legge Fallimentare", Bankruptcy Law), which sets forth the automatic termination of the contracts at the date of bankruptcy declaration, easing the close-out netting of transactions.

4.1. Netting Opinion about execution of Master Agreements (ISDA and GMRA) and confirmations in Italy

Article 76 of the Italian LF (bankruptcy law), at the regard of Italian derivative financial instruments, forward transactions on currencies, securities lending, and securities sale and repurchase (the latter being equivalent to REPOs and to GMRA), places the rules:

- that such contracts are immediately terminated at the time of the bankruptcy judicial declaration,
- that shall be performed the operations of netting or of set-off and
- that the active credit balance, if any in favour of the Italian bankrupted company, shall be paid to the organs of bankruptcy (curator, "Curatore Fallimentare").

Further, "*all contracts, even if not executed in whole or in part, entered into within the date of declaration of bankruptcy or of effectiveness of compulsory measure of administrative liquidation*" are included (thereby acknowledging what is already happening in the international practice under the ISDA contractual provisions).

A further contribution to solve, even partially, the grey areas was offered by so called *Collateral Directive*, integrated into Italian law by Legislative Decree no. 170/2004 on financial collateral (hereinafter "Decree 170"). Decree 170 should be recognized, primarily, for the merit of having insured the validity and enforceability of close-out netting clause "even in case of reorganization or liquidation procedure against one of the parties". In addition, its definitions of reorganization and liquidation proceedings are so broad as to cover substantially all of the cases of liquidation, which involves any intervention by administrative or judicial authorities and any measure aimed at restructuring companies.

However, the new rules do not imply the total non-application of current bankruptcy laws, which instead can interfere with close-out netting procedures, for example, in cases of fraud. Namely, the conclusion of the netting agreement can be construed by the judge as having the purpose of fraudulently favouring certain creditors, and the revocation of fraudulent acts referred to in Article. 66 L.F. could make him declare ineffective any acts (also an ISDA or GMRA) made by the debtor to the detriment of creditors (detriment evaluated in accordance with the provisions of the Civil Code).

Effectively, the set-off clause of GMRA or the close-out-netting of ISDA, in case of early termination and/or event of default, could find a further limit of enforcement in the special legal institute of temporary business operations of the company under the judge-control ("Esercizio Provvisorio dell'Impresa"), even if concerning only specific branches. The Bankruptcy Law provides that "during this temporary operations pending contracts can continue to be in force, unless the curator does not intend to suspend their execution or terminate them" (Article 104, par. 7 LF). In other words, if the scheme has been activated, the fulfilling party of an ISDA cannot invoke the clause of close-out netting.

Anyway, this prospective suspension or termination of single transactions by the curator seems to be paralysed by the fact that he could not easily choose which transactions keeping alive and which terminating, and this by virtue of their contractual unity with the Master Agreement, typical of Master Netting agreement. Overall, if the judicial curator, during the temporary business operation, is unable to fulfil its obligations under the transactions in place, the non-defaulting party (European Bank) would still have the right to terminate the contract,

in accordance with the provisions of the ISDA or the provisions of the GMRA. So, it is sure that by virtue of the termination for breach, the close-out netting clause would anyway operate, thereby preventing the curator from doing a selective disregard of derivatives operations (so-called "cherry-picking"), i.e. the maintenance of those which express a positive balance for the bankruptcy asset and a termination of those at a loss.

It is important to notice that it is recommendable that ISDA credit support documentation (CSD) about collateral has preferred title transfer arrangements subject to English law: under Italian law such arrangements are deemed vulnerable to re-characterisation as disguised security, according to art. 9 of Decree n. 170 (these schemes could be recognised as valid and enforceable only if falling in the category of "repos"). Also absolute transfer of transfer mechanisms outside repo (such as under an English law ISDA Credit Support Annex) may not be recognised for the same reason.

Any special consideration deserves the following remarks:

- In Italy top-up collateral delivered in a specified period prior to the commencement of insolvency may be declared ineffective.
- Italian systems has any differences in the valuation of obligations and currency conversions, namely, there are mandatory rules for this valuation (with reference to replacement costs, using market values at the date of the declaration of insolvency).
- Firm-specificity of collateral can impede rapid liquidation of collateral, free from any bankruptcy or insolvency moratorium (seizure or else), differently from non firm-specificity of other collateral as securities and receivables.
- Fortunately, if an Italian company is not a bank, therefore the automatic and immediate termination of any pending transactions, plus the close-out netting clause, pursuant to Article 203 of TUF cannot be subject to the typical delayed set-off of obligations which can concern credit institutions (Italian Banks) pursuant to art. 95-ter of Italian Banking Law (Legislative Decree no. 385 of 1 September 1993, article 95-ter).

Therefore:

- The close-out netting mechanism of ISDA master agreement and/or the alternative set-off mechanism of GMRA master agreement, provided by their respective clauses of early termination in case of events of default or of termination events, are enforceable in Italy (relevant laws: art. 203 of TUF and legislative decree n. 170 of 2004).
- These clauses will be unconditionally executed and enforced, prevailing over every kind of domestic rules of insolvency or bankruptcy law. Namely, the set-off or close-out netting will be completely ruled by the law of contract (*lex contractus*), which will exclusively govern any netting operations of early terminated transactions without interference from the relevant domestic insolvency or bankruptcy law (which will not cause delay in terminating and netting outstanding transactions between the parties).
- This Netting Opinion covers corporations, investment funds, broker dealers, investment firms, fund management funds and foreign and Italian banks (excepted any specific cases relating to Italian bankrupted banks, as set forth by art. 95-ter of Banking Law).
- All transactions are eligible, except those related to top-up collateral delivered in a specified period prior to the commencement of insolvency and collaterals characterized by firm-specificity.

4.2. Enforcement of foreign judgment or arbitration award in Italy

Any choice of foreign law and jurisdiction, or of arbitral jurisdiction, raises the question of effective enforcement in Italy of foreign judgments, especially in the case of disputes about the mechanism of close-out netting (related to events of default). The choice can fall on English or European law and jurisdiction, but it shall be remembered that English law is the most frequent choice.

At the moment, according to Italian Law no. 218 of 31 May 1995 (art. 64), the recognition of foreign judgments in Italy no longer requires a special procedure if a number of conditions, mostly regarding previous procedural guarantees, are satisfied during the past judicial phase. These conditions are the following:

1. The foreign judgment is recognized in Italy without being required any special procedure when:

a) the judge, who held the decision, could hear the case according to the principles of jurisdiction accepted by Italy;

b) the introductory act of the proceedings was brought to the attention of the defendant, in accordance with the provisions of the law of the place where the trial was held, and the essential rights of the defense were not violated;

c) the parties were convened before the court according to the law of the place where the trial was held, or their default was declared in accordance with this law;

d) the judgement became *res judicata* in accordance with the law of the place in which it was decided;

e) the judgement was not contrary to any other judgment pronounced by an Italian court and definitive become;

f) a trial was not pending before an Italian court for the same matter and between the same parties, which began before the foreign process;

g) the provisions of the judgement did not produce effects contrary to public policy.

2. The same conditions apply to arbitral awards, according to art. 4 of Law n. 218 of 1995 (International Private Law).

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