OTC DERIVATIVES: SALIENT PRACTICES AND DEVELOPMENTS RELATING TO STANDARD MARKET DOCUMENTATION§

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Abstract. Since its inception in the 1970s, the over-the-counter (OTC) derivatives market has developed at a fast pace. The market for derivatives is still largely unregulated. Through the efforts of private international associations such as ISDA, however, an element of standardisation has been achieved via the proliferation and global use of standard contractual documentation. This paper illustrates this by analysing the architectural structure and main features of the 1992 and 2002 ISDA master agreements. ISDA has also sponsored legal opinions on jurisdictions worldwide on the enforceability of the close-out netting provisions contained in its master agreements. The paper recommends that parties should seek legal advice when departing from the standard close-out netting provisions as proposed in the ISDA master agreements.

Introduction

The over-the-counter (OTC) derivatives market has had the fastest growth rate when compared with other financial market instruments. The first derivatives in the form of swaps were executed in the mid-1970s, first taking the form of currency or foreign exchange swaps and, later in the 1980s interest rate swaps emerged. Currency swaps were developed in order to circumvent barriers such as exchange control restrictions which impeded the international flow of funds. Since then the derivatives markets have become highly complex and diversified. Thus, credit derivatives have been developed to protect investors (normally in the wholesale markets) from adverse risks which could affect underlying investment transactions. Derivatives have also made their way into the trading of energy products, rationalising as a consequence the wholesale distribution of energy. More

§ The views expressed in this article are the personal views of the author and do not necessarily reflect those of the ECB.

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recently, derivatives have been used to manage the risks associated with the environment, and in particular to reduce the negative impact of global warming.

The Nature of Derivatives Explained

The OTC derivatives market, still largely unregulated by supervisory regulators, is organised and managed by the major global dealers acting through the International Securities Dealers Association Inc. (ISDA) and its standard market documentation and definitions.

A derivative, as the name suggests, is an instrument whose value derives from something else, such as an asset or an index (for a more in-depth definition see Henderson, 2003:3). The derivative, however, is treated as having a value which is separate from the value of the underlying asset or index. The parties’ rights and obligations can be treated as if they constitute a separate asset and are typically traded accordingly. Thus, in an equity derivative there is no real purchase of shares in a company but instead the instrument entered into is linked to the level of a share price. This type of contract can be used to protect investors from market risk. Hence, if the (real) shares bought by an investor fall in price, the investor might buy equity derivatives to allow the investor to sell the shares at an above-market price. In this way, a derivative may serve as insurance cover or, to use market terms, to hedge an open transaction.

Derivatives have been associated with many of the financial crises or turmoil of the last twenty years. After the emergence, and subsequent proliferation, of currency and interest rate swaps, the derivatives business became more complex. The more innovative and complex the derivative, the higher was the margin earned. The extremely low interest rate scenario of the early 1990s fuelled the growth of derivatives as bankers sought to create newer instruments to help investors achieve better returns. In 1994 the interest rate climate suddenly changed, causing many derivatives contracts to register huge losses.

Derivatives activity slowly recovered by the mid-1990s. However, by this time, most derivatives had been copied so widely that they became a mass-market product with a low-margin. Again, the bankers’ innovative ideas
came into play and a new type of derivatives emerged: the repackaging and selling of loans on bankers’ books,¹ thereby diverting the risk of non-payment onto investors.² As these instruments started to be copied globally and the margins started falling, bankers put in riskier assets into the packages, such as subprime mortgages whereby loans extended to borrowers with a poor credit history found their way into these bundles of instruments.³

In the light of this, numerous types of derivative products are today in existence and it would be a mammoth task to describe them all. It is possible, however, to identify basic types or classes of derivative contracts, the most fundamental being swaps, options, forwards and futures:

• A swap is a transaction where two parties exchange one stream of cash flows against another stream over a period of time. Thus, in a plain vanilla interest rate swap, one party pays a fixed interest rate and the other pays a floating interest rate on a specified notional amount over a span of time. This notional amount is not exchanged between the parties (unless different currencies are being swapped) and so, unlike a loan, no borrowing is involved.

• In an option one party agrees to pay the other party for the right (but not the obligation) to buy or sell something at a future point in time. There are two basic types of option: (i) a call option which gives the holder the right to buy the underlying asset (e.g. shares) by a certain date for a certain price and (ii) a put option which gives the holder the right to sell the underlying asset by a certain date for a certain price (e.g. a put option regarding a particular stock where the put option buyer hopes that the market price of the stock will drop in the time it has to exercise its right to sell to the put option seller). The first involves physical settlement and the second cash settlement.

• A forward contract is an agreement between two parties to buy or sell an asset at a certain time in the future for a certain price. Alternatively, it can

¹ These came to be known as “synthetic collateral debt obligations” or “collateralised debt obligations” (CDOs). CDOs bundle together bonds, loans or swaps; but they have different tranches that give investors different rights over the portfolio. Thus, as interest payments on the underlying bonds are distributed, these will first be allocated to the senior tranches. Only when these have been paid will the more junior tranches get their share. And if defaults occur, the junior tranches take the first hit.

² Indeed, one way how the financial industry survives a financial crisis or turmoil is to restructure its loss-making investments into something innovative.

³ Asset-backed securities, including those linked to subprime mortgages, have been bundled together and sold as residential mortgage-backed securities (RMBS) and these were bought by CDOs. With the recent massive default in payment by subprime borrowers, the problems and losses have filtered down not only in the junior, but also up to the senior, tranches of CDOs.
be a contract under which one party has the right to receive/payment if the asset (or an index) increases in value and the other party has the right to receive a payment if the asset or index decreases in value between two dates.

• A futures contract, which is somewhat similar to a forward contract, is an agreement between two parties to buy or sell an asset at a certain time in the future for a certain price or to receive or make payment depending on the increase or decrease in value of an asset or index. Futures, however, are traded on an exchange (contrary to a forward which is an OTC derivative). Futures are standard contracts, comprising the majority of all on-exchange transactions, which can be subdivided into commodity futures, where the underlying asset is a commodity (e.g. metal) and financial futures, where the asset is a financial instrument. Futures, unlike forwards, are rarely settled physically (even though the obligation under the contract may provide for the delivery of an asset), since market participants often close out their positions by entering into an offsetting contract before the settlement date occurs, so that an obligation to deliver an asset under one contract is matched by a right to take delivery of the asset on the same date under the other.

These are the main types of derivatives contracts from which related products are derived. Related products normally represent further complex arrangements based around the original, less exotic, prototype.

Thus, a variation of an interest rate swap is an interest rate cap. A cap is a transaction under which one party agrees to pay a floating rate to the other if the rate exceeds a specified level. Just as there are caps, there are also floors and collars. A floor, in contrast with a cap is a transaction under which one party agrees to pay a floating rate to the other if the rate is less than a specified level, so that it is only exposed to interest rates to the extent that they exceed the floor but is protected against the risk of the rate falling below this level. A collar involves both the sale of a cap and the purchase of a floor. Under such a transaction, one party agrees to pay a floating rate to the other if the rate is less than another lower level.

Swaptions are similar to options, however instead of exercising an option to acquire or dispose of an asset (or the payment of a cash sum based on any change in value), the option would be exercised in relation to a swap. A swaption may also be cash settled and in this case the seller would have to pay a sum equal to the market value of the swap on the exercise date.
Setting Standards Through Contractual Documentation

Exchange-traded derivatives products are standardised products with very limited variations. An OTC transaction, on the other hand, is a privately negotiated contract on whatever terms the parties agree. Although the OTC derivatives market is not yet subject to ad hoc regulation, a certain element of standardisation in this market has been achieved through the resort on a global scale to standard market documentation which serves both to enhance protection and to reduce the time needed to negotiate contractual terms.

ISDA has been at the forefront in bringing about this development. ISDA represents participants in the OTC market and is the largest global financial trade association. Its members include most of the world’s major dealer institutions which trade in OTC derivatives, as well as governmental and other commercial entities (known as ‘end users’ to distinguish them from the major dealers) that rely on OTC derivatives to manage efficiently the financial market risks inherent in their core economic activities.

Since its inception ISDA has developed standard market documentation to reduce risk and shape the derivatives industry in which its principal members, i.e. the major OTC derivatives dealers, operate. Its most notable achievement has been the development of the ISDA master agreement, initially in 1987 to cover interest rate and currency swaps, and later revised in 1992 and again in 2002 and made applicable to OTC derivatives generally. ISDA has also published a wide range of related documentation covering a variety of transaction types, including documents on definitions of certain products intended to streamline the process of supporting trading activities in the financial derivatives market through the promotion of language for describing these products. ISDA also produces legal opinions on the enforceability of netting and collateral arrangements, which are made available only to its members, and cover the laws of a substantive number of jurisdictions over the world.

The 1987 version is, by and large, no longer used by the business community. On the contrary, the 1992 version has proved resilient over time and, given

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4 See the website of ISDA: www.isda.org.
5 References to the ISDA Master Agreement in this article are intended to constitute reference to the Multicurrency – Cross Border ISDA Master Agreement (and not to the Single Currency – Single Jurisdiction version).
the tendency to stick to agreements that one is familiar with, there has not been a total migration to the 2002 master agreement. The 2002 version has a few useful new features such as a force majeure termination event clause, set-off provisions and a new method of calculating close-out payment amounts. In other respects, both these versions are identical and it is therefore proposed to examine the main provisions of both the 1992 and 2002 versions of the ISDA master agreement in this article.

Key Features of the 1992 ISDA Master Agreement

The ISDA master agreement, like most of the other master agreements published by other market associations, consists of (i) the standard agreement (the ‘ISDA master agreement’) which governs the general contractual relationship between the parties, (ii) the ‘Schedule’ used by the parties to negotiate terms in the standard agreement or to provide for new, additional provisions and (iii) the ‘Confirmation’ which sets out the economic and financial terms of the individual transaction being entered into and which may incorporate by reference one or more standard ISDA Definitions booklets, depending on the type of transaction being traded. The confirmation may also include information such as addresses for notices specific to the parties. Through the confirmation, each transaction is expressly made subject to the terms of the master agreement. The ISDA master agreement and the schedule are signed only once by the parties to govern all their OTC derivatives, whilst the confirmation is exchanged or countersigned each time a new transaction is entered into. This form is intended to reduce the time needed to negotiate contracts and to permit a substantial degree of standardisation for the operational execution of transactions, which is normally automated and has become, for most purposes, an off-the-shelf

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6 The ISDA master agreement provides a hierarchy rule in case of a discrepancy or conflict between the various documents. Thus, in terms of Section 1(b), in case of an inconsistency between the schedule and the master agreement, the schedule prevails (precisely because the scope of the schedule is to further define or change the provisions of the master agreement) and in case of inconsistency between the provisions of a confirmation and the master agreement including the schedule, the confirmation will prevail for the purpose of the relevant transaction it is meant to cover. It should be noted, however, that the scope of the confirmation is to set down the economic terms of the relevant transaction and it is not appropriate to use the confirmation to settle legal terms as this can only delay the conclusion of the transaction and would defy the scope of having a master agreement with accompanying schedule which sets down (once and for all) the legal basis of past, present and future transactions.
software product. User’s Guides published by ISDA explain the terms and provisions of the master agreement.

The governing law of the ISDA master agreement is either English law or New York law, which is probably the case because, in the words of Professor Hudson, “(these jurisdictions) are considered to have the most mature systems of commercial law (and) ... there is unparalleled judicial expertise in dealing with international commercial disputes.”

Hudson draws attention to the fact that since both of these systems are common law systems, they are susceptible to change through court decisions without the need of any legislative intervention. The result could well be that a court judgement renders ineffective or void any part of the master agreement without any of the parties thereto ever being aware of it (Hudson, 2002: 124).

The most important provisions of the master agreement relate to the events of default and termination events. The occurrence of either of these could lead to the termination of (all or some, as explained below) outstanding transactions governed by the master agreement, enabling the set-off of amounts due by one party to the other to enable the calculation of a single net exposure (referred to as ‘close-out netting’ amount which would be paid by only one party to the other).

**The Events of Default**

The events of default listed in the master agreement are intended to identify circumstances where the risk of non-performance is considered so great that the basis of the relationship between the parties is deemed to have broken down. It enables the non-defaulting party to crystallise its exposure by closing out, thus avoiding a potential increase in exposure as a result of the inability of the counterparty to perform its obligations, and to take enforcement proceedings to recover the full amount due before the defaulting party commences winding up or administration proceedings. These events of default, similar to those found in loan agreements, comprise:

- failure to pay or deliver under any of the payment or delivery obligations (subject to notice and grace periods, e.g. because the failure may be due to a technical error which can be remedied);
- any breach of other provisions of the master agreement (subject to notice
and longer grace periods, since these breaches are considered less serious than a failure to pay or deliver and may take longer to remedy, e.g. the case of a failure to obtain the necessary regulatory consents);

• a default under any credit support document (e.g. guarantee or collateral arrangements which have become enforceable) which supports the obligations of any of the parties, whether given by the party itself or by a third party (the credit support provider). This event also covers cases where a credit support document becomes ineffective or the person bound by it repudiates it or challenges its validity

• any misrepresentation other than payer or payee tax representations since the financial burden of any withholding tax is placed on the party in breach;

• a default under other derivative transactions (referred to as ‘Default under Specified Transaction’) not governed by the master agreement between the parties, their credit support providers or any of the entities specified in the Schedule (usually affiliates of the parties, called ‘Specified Entity’). Three defaults are covered: (i) a default resulting in the acceleration or close-out of a specified transaction, (ii) a default occurring on the last payment or delivery date for such a transaction (where the default is not remedied at the end of any grace period or, in the absence of a grace period, within three business days) or (iii) a repudiation or disclaimer of such a transaction;\footnote{In the case of the 2002 master agreement, such a default may also including challenging the validity of such a transaction.}

• a cross default by either of the parties or any credit support provider or any specified entity under an agreement relating to any obligation (“Specified Indebtedness”) in respect of borrowed money which exceeds a predetermined threshold amount. This could be either a default through which the specified indebtedness has been accelerated or is capable of being accelerated, or it is a payment default in excess of the threshold amount;\footnote{This event has to be specifically selected by the parties in the schedule to apply. Its usefulness is sometimes limited since it is usually difficult for the non-defaulting party to realise that a cross-default has occurred.}

• bankruptcy of any of the parties, credit support provider or specified entity. This event covers a number of insolvency-related events, including dissolution, insolvency, arrangements with creditors, commencement of insolvency proceedings, winding-up resolution, appointment of insolvency official, enforcement actions, and analogous events and action in
furtherance of or indicating consent, approval or acquiescence in any of these events;

- merger of a party or the transfer of all or substantially all of its assets to another entity without transferring the obligations under the master agreement or without ensuring that any credit support document remains in force. In the case a party transfers some (but not all or almost all) of its assets to another entity, there is no event of default, but such transfer would require the consent of the other party.

Termination Events

Termination events comprise the following:

- illegality arising out of any change of law or change in the interpretation of law\(^9\) which makes it unlawful for a party to make any payment or delivery due from it or to comply with any material obligation, or for any obligation arising under a credit support document to be performed. The term ‘unlawful’ is to be widely construed to refer to breach of any treaty, law, rule or regulation of the jurisdiction where performance is required;

- a force majeure which makes performance by either party to make or receive any payment or delivery due under the master agreement or any credit support document, or to comply with any material provision, impossible or impracticable (this is only provided for in the 2002 version) and this event persists for eight business days. If the impossibility or impracticability is due to performance becoming unlawful, the illegality event of default will take precedence and no force majeure event will occur as a result;

- the imposition, or substantial likelihood of its imposition, of a withholding tax due to a change of law. In this case the affected party is the party that suffers the financial burden of the withholding tax, namely the party having to gross up (where the other party has no connection with the jurisdiction imposing the tax) or the party suffering a deduction of tax on the payments due to it (where there is no such connection);

- the imposition of a withholding tax due to the merger of a party or the transfer of all or substantially all of its assets to another entity. It is the party which is the subject of the merger or to which the assets have been transferred that is treated as the affected party, regardless of whether it suffers the financial burden of the withholding tax that arises as a result of the merger;

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\(^9\) An event which constitutes both an event of default and an illegality is treated as a termination event.
merger of a party or a similar corporate restructuring resulting in the party’s credit being materially weakened. This will be the case where a company in a strong financial position merges with a much weaker one, i.e. where the credit-worthiness of the entity resulting from the merger or (under the 2002 version) the entity to which a substantial part of the assets or shares in the company are transferred, is materially weaker than that of the original party;

any other additional termination event or events specified by the parties in the schedule or a confirmation. An additional termination event that is often included relates to the downgrading of the credit worthiness of one of the parties (and may also include their affiliates or any credit support provider), so that if the credit rating falls below a certain level this would constitute a termination event.

Whilst both termination events and events of default could lead to the close-out of transactions, there are some important differences. Thus, termination events may not be considered as occurring due to the ‘fault’ or culpability of one of the parties. Whilst the occurrence of an event of default could lead to the termination of all outstanding transactions, under a termination event only the transactions affected by the event are terminated and, for certain events, this is possible only after an attempt is made by the affected party to transfer those transactions to another office or affiliate in an attempt to remedy the occurrence. For some events, either party can close-out the affected transactions (in case of events of default, only the non-defaulting party can initiate action) and if the obligations of both parties are affected by a termination event, then both are responsible for calculating the close-out payments. Finally, if a termination event occurs, each party whose obligations are affected by it must notify the other party promptly upon becoming aware of it. There is no requirement to notify the occurrence of an event of default.

**Withholding Tax**

Since a derivative transaction may not be a good deal if a withholding tax is levied on payments or deliveries, each party is expected to make certain payer tax representations in the Schedule to confirm the absence of any withholding taxes in their respective jurisdictions. In order for the parties

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10 In case of force majeure under the 2002 master agreement, each party has an obligation to notify the other (Section 6(b)(i)).
to make these representations, the payer may need to establish that the payee meets certain specified criteria (through payee tax representations) or may need the payee to complete certain tax forms. Where a withholding tax becomes due and it is established that the withholding tax was due from the outset, the payer will be obliged to gross-up its payments\(^\text{11}\) provided that: (a) that tax is not an ‘Indemnifiable Tax’ (i.e. tax imposed due to a connection between the jurisdiction of the recipient and the taxing jurisdiction); (b) it is not due to the payee tax representations being untrue; and (c) it is not due to a failure by the recipient to deliver any tax forms. If a change in law results in the imposition of a withholding tax, the payer is burdened with a gross-up obligation, although this may result in a termination event.

Automatic Early Termination

Another key feature of the ISDA master agreement is the automatic early termination clause. If this provision is selected to apply in the schedule, on the occurrence of certain specified events related to the bankruptcy event of default, an automatic close-out of all transactions is deemed to have occurred before the commencement of the insolvency proceedings (and thus no notification by the non-defaulting party is required). This provision, if selected, should be selected with care since legal opinions of various jurisdictions indicate that an automatic close-out may not be possible prior to the commencement of insolvency proceedings (or may be interpreted by domestic courts to apply upon the commencement of insolvency proceedings). In addition, the benefit of automatic close-out has to be weighed against any disadvantage that may arise from an inability to close-out any back-to-back hedging transaction due to the party not being (immediately) aware that an automatic close-out has occurred.

Payments on Early Termination

The amount payable on close-out of all outstanding transactions depends on which version of the ISDA master agreement is used. Under the 1992 version the parties must choose between the ‘Market Quotation’ and the ‘Loss’ method. Under the first option, the party making the calculations obtains quotations (at least three, but preferably four) from leading dealers in the

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\(^{11}\) Grossing-up implies that the payer is required to pay a larger amount in a way that the payee still receives the amount it had anticipated after deduction of tax by the payer.
relevant market for a replacement transaction.\textsuperscript{12} The second option, used for the more complex structured transactions, entitles the calculating party to determine the total losses and costs/gains arising out of a close-out.\textsuperscript{13} This is, evidently, the more subjective method. The loss method may be applied even if market quotation is selected if the calculating party reasonably believes that using market quotation may produce a commercially unreasonable result.\textsuperscript{14} Market quotation applies by default if the parties fail to select a method in the schedule.\textsuperscript{15}

The 2002 version provides for a combined market quotation/loss calculation mechanism and requires that the calculation is based on the cost that would be incurred in replacing the rights and obligations that have been terminated or the gain that would be made in doing so. Hence, this mechanism has the features of the market quotation method, with the difference that the cost is not necessarily determined by reference to quotations obtained from dealers. This is meant to provide for times of market turmoil when it may be difficult

\textsuperscript{12} In terms of the definition of ‘Market Quotation’, each quotation is the amount the dealer would require from (a positive amount) – or would pay to (a negative amount) – the relevant party for the dealer to enter into an agreement with that party providing for a new replacement transaction (or group or groups of transactions, as the case may be), that would have the effect of preserving for such party the economic equivalent of any payment or delivery (whether the underlying obligation was absolute or contingent and assuming the satisfaction of each applicable condition precedent) by the parties. In providing such quotations, the dealer is to take into account any existing credit support document with respect to the obligations of such party. The highest and lowest quotations are disregarded and the market quotation for the terminated transaction or group of terminated transactions is the average of the remaining quotations. (Section 14, 1992 ISDA master agreement).

\textsuperscript{13} The definition of ‘Loss’ provides that the calculating party may include any loss of bargain, cost of funding or, at the election of such party but without duplication, loss or cost incurred as a result of its terminating, liquidating, obtaining or re-establishing any hedge or related trading position. Alternatively, the calculating party may obtain market quotations for rates and prices. (Section 14, 1992 ISDA master agreement)

\textsuperscript{14} See Peregrine Fixed Income Ltd (in Liquidation) v Robinson Department Store PLC (18 May 2000, Commercial Court, Claim No 2000-Folio 277) where the court proceeded to use the loss method, even though market quotation had been selected by the parties, on account of the unreasonable quotations obtained by the calculating party.

\textsuperscript{15} Besides the choice of calculation mechanism, parties should also choose between ‘First Method’ or ‘Second Method’, with the second method applying by default. Under the first method, the amount resulting from the calculation method, if positive is payable by the defaulting (or affected) party to the other. If the amount is negative, the non-affected party would pay the absolute value of that amount to the affected party, but there would be no obligation on the non-defaulting party to make any payment to the defaulting party. Alternatively, under the second method the non-defaulting party would pay over the absolute value of the negative amount to the defaulting party. (Section 6(e), 1992 ISDA master agreement)
to obtain representative quotations. Under both agreement versions, payment is always accompanied by the payment of interest.

Close-out Netting

The process of calculating the final close-out amount rests on the ability of the parties to the master agreement to perform close-out netting. Close-out netting is the process by which, upon the occurrence of a particular event, whether related to insolvency or otherwise, all obligations owed by two parties become due and, especially in the case of delivery obligations, are converted into monetary claims so that a single amount is owed by one party to the other. Close-out netting is an important way of reducing credit exposure, and, consequentially, systemic risk. If market dealers are able, in a close-out or termination situation, to treat the individual exposures owed under each transaction entered into under a master agreement aggregately so that only one net amount becomes due, this would greatly reduce credit exposure. If this occurs in an insolvency situation, close-out netting could substantially help to prevent the domino effect whereby the insolvency of a major dealer could bring about the insolvency of other market players to which it is exposed with the result that the market ceases to be viable.\textsuperscript{16}

Confirmations

A trade is usually agreed by a recorded telephone trade call which is considered to bind the entities of the dealers having made that call. It is standard practice, however, to confirm a trade in writing after the call. This is normally done two days after the trade date and is done by the exchange or countersignature of confirmations containing the complete terms of the transaction. At times a trade may need to be rebooked because through confirmations the dealers discover mistakes in the trade call.

\textsuperscript{16} Close-out netting constitutes a clear departure from the pari passu or paritas creditorum principle (i.e. the principle that all creditors are treated in an equal manner) since, in the event of a ranking of creditors for the insolvent party’s estate, the solvent party is able to retain payment, up to the amount of what is owed to it by the insolvent party, ahead of the latter’s other creditors. For a more detailed exposition of the effects of close-out netting clauses and their protection under national laws, vide article by the author of this paper on “Developments in netting legislation: the silent revolution in the financial markets”, Butterworths Journal of International Banking and Financial Law, October 2008: 470-472. Lexis Nexis UK.
The exchange or countersignature of confirmations is important for a number of reasons. Tapes of recorded telephone conversations are normally destroyed after a number of weeks or months so that only the confirmations remain to evidence the transaction. Moreover, as stated above, the dealers would not have settled all details of a transaction in a trade call since under the ISDA master agreements, and in particular under the ISDA Definitions booklets, certain elections must be made in the confirmations. Under the 1992 ISDA master agreement, the term “Confirmation” is limited to any documents or other confirming evidence that have been exchanged between the parties in respect of a transaction. It would appear that if such exchange has not taken place, there would be no confirmation and so the transaction will probably be excluded from the close-out netting provisions of the Agreement. Under the 2002 master agreement, the matter has been resolved since the agreement defines “Confirmation” to include anything which evidences a transaction so that it may even include the parties’ internal records.

ISDA has further developed master confirmation agreements with standard choices so that almost all significant elections from available definitions are pre-agreed with only minor or few variations applicable to different regions need be made.

Although normally it should be sufficiently clear from the trading relationship between entities that they intend all their OTC derivatives trading to be governed by the master agreement signed between them, it is recommended that the parties include a reference in their confirmations to their respective master agreement to ensure the applicability of the single master agreement concept (i.e. that all transactions entered into by the parties are deemed to be governed by their respective master agreement) and the possibility to close out in case of the occurrence of an event of default or, if applicable, a termination event.

Legal Opinions

As reiterated above, ISDA has sponsored legal opinions on a substantive number of jurisdictions worldwide regarding the applicability and enforceability of the netting provisions and collateral arrangements relating to the ISDA master agreements (all versions). If the parties to a master agreement intend to deviate from the wording contained in the standard
agreements, it is recommended that they ensure that such changes do not render the legal opinion inapplicable or the netting provisions unenforceable. Although the ISDA master agreements are governed by New York law or English law (and it should be expected that their provisions are enforceable under the laws of these jurisdictions), it is necessary to ensure that the close-out netting provisions are not rendered unenforceable by the insolvency or proprietary laws of another jurisdiction in which one or both of the parties are located or are doing business. It is mainly for this reason that the laws of jurisdictions other than New York and England need to be checked. The issue becomes more complex in case of multi-branch netting where parties conclude a master agreement and then trade or settle through their foreign branches. In such case the laws of each jurisdiction that may be involved needs to be analysed to ensure that close-out netting through all these individual branches may be enforced in an insolvency situation.

**Conclusion**

At this time of market turmoil, the provisions of the ISDA master agreements (as with other master agreements) are currently being tested as market participants grapple with the protection afforded by these agreements, in particular by the termination and close-out provisions, in an effort to minimise their losses or recuperate amounts due. In particular, the winding-up of the US entity Lehman Brothers has raised various questions on the applicability and effectiveness of the ISDA master agreements such as the enforceability of cross-affiliate set-off, the use of the market quotation to calculate close-out amounts under the 1992 ISDA master agreement\(^{17}\) and in general the problem of ascertaining asset prices in cases where these assets no longer have a current market value.

It is through these painful experiences that lessons are learnt and master agreements are further strengthened. But there is of course a limit to what can be achieved through contractual arrangements and it is equally, if not more important, that domestic laws are also revised to ensure the protection, and consequently the stability, of the operators in the financial markets.

\(^{17}\) Indeed, since market prices for various assets are not available in the current market turmoil, the major dealers acting through ISDA have entered into multilateral agreements to convert the calculation of market quotation under their 1992 ISDA master agreements to the close-out calculation provided for under the 2002 ISDA master agreement.
References


