REVIST@ *e* – *Mercatoria* Volumen 11, Número 1 (enero – junio 2012)
(Rev. e-mercatoria)

Introductory aspects on financial derivatives market: ISDA master agreement dealing with legal risk?[♦]

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Abstract

This article being the first of a serie of articles, treats the very general aspects of Financial Derivatives Market. Explains the division in Stock Excahnge and OTC Market. It is focused on the study of the main issues identified under the current financial crisis. Then, to explain the basic of the most commonly used derivatives transactions. To follow with the structure of the ISDA Master Agreement, its features regarding legal risk and the pending topics not covered.

Keywords: Financial Derivatives, Legal Risk, ISDA Master Agreement.

Resumen

Este artículo siendo el primero de una serie de artículos e investigación sobre el tema, trata los aspectos más generales del mercado de derivados financieros. Explica la división en el Mercado en Bolsa y el Mercado al mostrador. Se centra en el estudio de los principales problemas identificados en este mercado en la actual crisis financiera. Explicar en forma general las operaciones más comúnmente utilizadas. Para seguir con la estructura del ISDA Master Agreement, sus características en cuanto al manejo del riesgo legal y los temas no comprendidos en el.

♦ Este artículo fue presentado a la revista el día 27 de marzo de 2012 y fue aceptado para su publicación por el Comité Editorial el día 14 de junio de 2012, previa revisión del concepto emitido por el árbitro evaluador.

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Palabras clave: Derivados Financieros, Riesgo Legal, ISDA Master Agreement

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1. Generalities

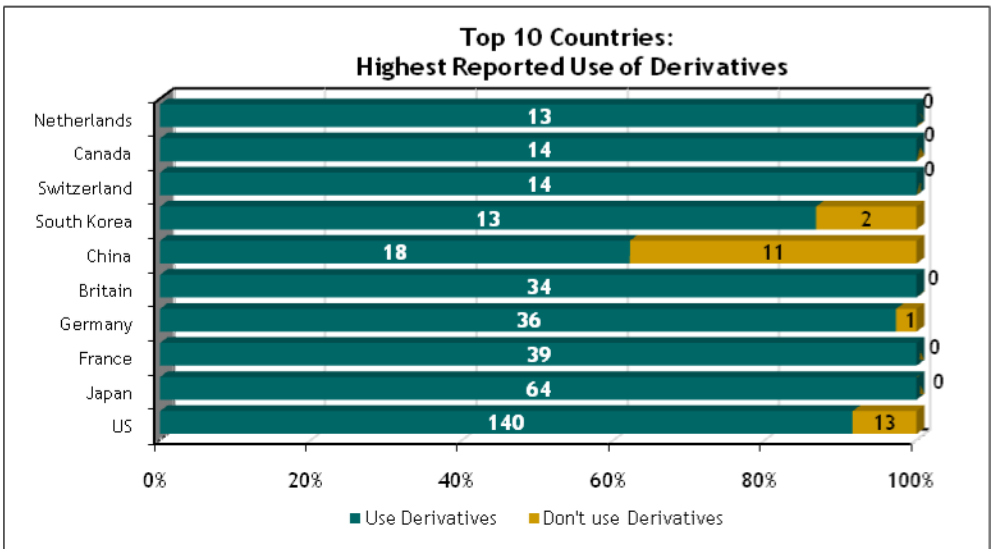
This article being the first of a serie of articles, treats the very general aspects of Financial Derivatives Market. Explains the division of this market in Stock Exchange Market and OTC Market. It is focused on the study of the main issues identified under the current financial crisis. Then, to explain the basic of the most commonly used derivatives transactions. To follow with the structure of the ISDA Master Agreement, its features regarding legal risk and the pending topics not covered.

To explain the derivatives market leads us to think on the two key financial markets London and New York. However, the Asian market is continuously growing and due to recent facts must also be taken into consideration. Within all these markets the derivatives contracts can be described as instruments of debt financing and rise of capital. They are tools open to financial and non-financial institutions, governments and private investors. The current use of derivatives is being continuously updated, is notorious how the Europe rescue plan includes financial transactions collateralised with derivatives. The new markets as Latin American markets are developing national regulations on derivatives market structure[3].

To show off the increased use of financial derivatives we would like to share this ISDA graphic[4]; which reports the top ten countries highest reported use of derivatives:

[3] However, the efforts have been put towards the enhancement of Exchange traded derivatives and not OTC Derivatives Market. The trend is accurately illustrated by Leonela Santana-Boado and Adam Gross United Nations Conference on Trade and Development (UNCTAD) Date 20/08/2007. In this sense: "The United Nations Conference on Trade and Development (UNCTAD) has been closely involved with Latin American commodity and derivatives exchanges for the best part of two decades. This article reviews the recent performance of these exchanges and their efforts at regional cooperation, and examines an enduring strength of Latin American exchanges – their capacity to innovate in a way that has seen exchange mechanisms applied effectively to address key challenges in these rapidly growing emerging markets".

[4] ISDA® INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC. NEWS RELEASE. Thursday, April 23, 2009. Available on http://www.isda.org/press/press042309der.pdf



Furthermore, the topic can be studied from two different perspectives: the regulation side attractive to governments and regulators; and the private side, it is the drafting of derivatives contracts tailored to investors' interests. The current work will be focused on the private side of financial derivatives. To explain the main features of the drafting procedure and how the use of international standards; as ISDA Master Agreement, contributes to reduce and manage legal risk.

The reason of standardisation is given by the fact; ISDA International Swaps and Derivatives Association gathers the market participants and is the forum to discuss market practices. Under this rationale, ISDA constitutes the place to present gremial interests and state them through general standards. Inasmuch, the documentation used in derivatives transactions helps to promote good practices. For instance, policies of transparency and disclosure; to show off clearing houses requirements and make them more open to almost all derivatives instruments.

Due to its composition ISDA is engaged with multiparty interests. The members are investors, clearing houses, practitioners, academics, banks among others[5]. Even though, the aim is to cover all the interested parties, the process of construction of its standards shall

[5] The list of ISDA members can be is available on http://www.isda.org/membership/isdamemberslist.pdf

answer the market needs. National and international conferences are done with all stakeholders' participation in order to consider different perspectives, opinions and interests. Therefore, the documents issued by ISDA are drafted procuring the maximum consensus.

To rule all types of derivatives transactions ISDA drafted and continuously reviews the ISDA Master Agreement. This is a standardised agreement that sets obligations, undertakings, representations and warranties that surrounds derivatives transactions. It clarifies the meaning of the most common terms and provides model clauses that are considerably useful by the time of drafting a derivative contract.

Since legal and credit risks are the most important risks to deal with; the ISDA documentation is focused on both of them. The legal risk is mainly generated by the existence of multiparty jurisdictions. Inasmuch, to apply national regulations commonly become roots of disputes, therefore the use of standard forms has gained land in the international financial market.

2. Current status of Derivatives Market

Different fields of financial markets were considerably affected by the deficiencies evidenced with lasts financial crises[6]. The derivatives market was one directly compromised[7]. Even though derivatives cannot be completely blamed for the financial crises, it is required the work of regulators and the actors of the market. Both of them are called to assume certain commitments and to provide a complete regulatory framework to address systemic risk in the future. Before deepen into OTC derivatives market and the use of ISDA Master Agreement, it

[6] The reference to 2008 and current financial crises.

[7] "Of course, they are instruments of Financial Risk Management also. Credit derivatives have always had their strong supporters and critics. Supporters argue credit derivatives allow investors to express their credit more efficiently and flexibly, and mitigate credit risk by spreading it among a wider group of investors. Critics, on the other hand, claim these same circumstances magnified systemic risk, especially given the difficulty of identifying counterparties and pinpointing where credit risk ultimately resided. Some complain that fair-value accounting requirements exacerbated the credit crisis for many financial institutions. But some industry leaders counter that if banks and other institutions had properly valued their risk exposures at the outset, they would have been in a better position to manage and reduce those exposures when the crisis hit." Eisinger, Jesse. Wall Street: The $58 Trillion Elephant in the Room. Available in http://www.portfolio.com/views/columns/wall-street/2008/10/15/Credit-Derivatives-Role-in-Crash/

is appropriate to enounce that Derivatives Market is divided into two parts: derivatives traded in exchange and the Over the Counter Market. The exchanged traded derivatives are usually governed by special rules set on the particular stock exchange. On the contrary, the OTC derivatives are "ruled" by the actors of the market. Therefore, topics as transparency, netting, risk management, clearing systems are specially concern for the OTC products.

In both markets there appear the concept of systemic risk, which has been defined as "the potential for a modest economic shock to induce substantial volatility in asset prices, significant reductions in corporate liquidity, potential bankruptcies and efficiency losses"[8]. However, this definition is not complete and some authors criticise it and propose to define systemic risk by explaining its process: "A common factor in the various definitions of systemic risk is that a trigger event, such as an economic shock or institutional failure, causes a chain of bad economic consequences—sometimes referred to as a domino effect. These consequences could include (a chain of) financial institution and/or market failures. Less dramatically, these consequences might include (a chain of) significant losses to financial institutions or substantial financial-market price volatility. In either case, the consequences impact financial institutions, markets, or both"[9].

The correlation between Derivatives Market, particularly OTC derivatives and systemic risk can be easily understood from the interest to mitigate the risk involved in transactions done within large complex financial institutions[10] [11]. One of the main objectives of financial

[8] Paul Kupiec & David Nickerson, *Assessing Systemic Risk Exposure from Banks and GSEs Under Alternative Approaches to Capital Regulation*, 48 J. REAL EST. FIN. & ECON. 123, 123 (2004)

[9] Steven L. Schwarcz. Systemic Risk. Duke Law School Legal Studies Research Paper Series Research Paper No. 163 March 2008. P, 198.

[10] Known as LCFI to denote major dealers/banks and others that are active in the OTC derivatives market.

[11] The recent financial crisis has provided an impetus to move the lightly regulated over-the- counter (OTC) derivative contracts to central counterparties (CCPs) rather than the bilateral clearing that has taken place to date.. The debate about the future of financial regulation has heated up as regulators in both the United States and European Union seek legislative approval to mitigate systemic risk associated with large complex financial institutions (LCFIs)". Collateral, Netting and Systemic Risk in the OTC Derivatives Market *Manmohan Singh*. International Monetary Fund WP/10/99 **IMF Working Paper** Monetary and Capital Markets Department.

derivatives is to understand and manage this risk. Indeed, ISDA one main aims is to be focus on counterparty credit risk.

In this sense, the fundamental guidance was set out by the G20 leaders that in September 2009 called: "*All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end- 2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse*"[12].

This commitment was endorsed by November 2010 Seoul Summit[13], when G-20 Leaders asked the Financial Stability Board to monitor OTC derivatives market reform progress regularly. There have been subsequent reports regarding the advances and pending tasks. Indeed, the current concern is around the compliance of these commitments by the deadline of 2012[14].

There are three deficiencies[15] that have been identified by the authorities and derivative market actors. They are: transparency and liquidity; risk management through the use legal documentation challenges in the ongoing changes of OTC derivatives market and the enhancement of central counterparty clearing system.

[12] The full text can be consulted at http://www.g20pittsburghsummit.org/

[13] The full text can be consulted at http://www.china.org.cn/business/hu_g20_apec/2010-11/12/content_21326615.htm

[14] According to lasts reports is not likely to achieve the above-mentioned reforms by the end of this year. Some countries have introduced regulatory policies, whilst others are still pending.

[15] The three deficiencies constitute the limits of the current research. The aim is to develop a very extensive work, in order to cover each of them in subsequent research articles.

Regarding the provision of greater transparency the aim established is to access to better information. However, this should be done avoiding an adverse impact on liquidity[16]. The legal reaction to transparency issues is centred on maintaining safe and efficient derivatives market. This is possible when there is an effective and comprehensive clearing system, adequate rules of report of information, and the constant update on terms of documentation requirements.

A tool already implemented is the registration of all relevant OTC derivative trades in a trade repository[17]. The goal is to facilitate regulators having accurate access to the information they need. In the case of the United Kingdom, the work is being done through the OTC Derivative Regulators Forum (ORF)[18].

In terms of transparency the debate is open. From industry perspective[19] the effects of the reform can affect liquidity to the extent to discourage the clients from derivatives and start to consider other products. While the argument usually presented by regulators and politicians is that transparency is good *per se*. The reality shows, however, that extreme transparency potentially hurts the client interests; especially in less liquid products. An intermediate view suggests transparency is a *condition sine qua non* of the market[20], agreeing that over transparency undoubtedly affects the market. Therefore, it is important to have the appropriate level of transparency.

[16] The so called negative impact on liquidity will directly depend on the type of product. In this regard see Journal of International Banking & Financial Law/2011 Volume 26/Issue 8, September/Articles/Regulating the unregulated: the prognosis for non-financial counterparties under the European Market Infrastructure Regulation - (2011) 8 JIBFL 469

[17] The recommendations stated by 2004 in the Committee on Payment and Settlement Systems (CPSS) of the central banks of the Group of Ten countries and the Technical Committee of the International Organization of Securities Commissions (IOSCO). Available in http://www.bis.org/publ/cpss64.htm

[18] Regulators in the ODRF seek to obtain a common understanding of the operations of and services being provided by OTC derivatives central counterparties (CCPs) and trade repositories (TRs) that serve the global market. http://www.otcdrf.org/work/index.htm

[19] ISDA Annual Conference September 2011. London-United Kingdom

[20] Some have argued, however, that restricting transparency provides benefits to large traders at the expense of small traders. Still others for example, the Office of Fair Trading in the United Kingdom, have questioned whether restrciting transparency may also reduce the speed with which market makers adjust prices, thereby reducing market efficiency. Bloomfield, Robert and O'hara Moureen. Market Transparency: Who wins, Who Loses? The Review of Financial Studies. Vol 12. N.1 1999. P.6.

The aim is to establish whether "the appropriate level of transparency" is a parameter that can be agreed by stakeholders. Or the process of shaping the product has a direct influence in the level of transparency required in each transaction. To determine how the tailored transactions can be regulated and supervised without having a negative effect in the market itself.

Following the structure of G20 recommendations ISDA main concern is the consistency of the structural market reforms[21]. Therefore, the first steps announced involve the documentation[22] to be used by the actors of the market. The task to review the documentation recommended by ISDA Master Agreement and its effectiveness. As well as, the efforts towards the effectiveness of the closeout netting as the tool to reduce and manage the risk in each transaction.

For the purposes of this article the documentation is an important part of the prospective of the market. To establish whether the already existent documentation is enough to deal with the appropriate management of risk; especially due to recent financial crises. However, the closeout netting requires to be briefly explained as main element of financial derivatives.

The concept of netting in general is used to refer the three main types of set-off and netting. They are: set-off, close-out netting and settlement netting. Set-off is defined as "the discharge of reciprocal obligations to the extent of the smaller obligation. It is a form of payment. A debtor sets off the cross-claim owed to him against the primary or main claim which he owes his creditor"[23]. The close-out netting is the cancellation of a series of open executor contracts between parties, eg a sale of goods or foreign exchange or investments, on the default of the counterparty and set-off of the resulting gains and losses. It requires two steps on a counterparty default: cancellation of the unperformed contracts, and then set-off of the gains

[21] Lee, Justin. Isda: Inconsistency among regulators worrying. 25 October 2011. Available under subscription in http://www.risk.net/asia-risk/news/2119674/isda-inconsistency-regulators-worrying

[22] Central to fulfilling ISDA's mission is the development and maintenance of a wide range of standard derivatives documentation, which facilitates the efficient documentation of transactions and promotes sound business practices. More information about ISDA can be found in http://www2.isda.org/

[23] Wood, Philip. Law and practice of International Finance. Sweet & Maxwell. 2008. P. 218

and losses on each contract, so as to produce a single net balance owing one way or the other. Strictly, three steps are required- cancellation, calculation of losses and gains, the set-off"[24]. Finally, the settlement netting is the "advance set-off by contract of equitable fungible claims under executor contracts, eg for commodities or foreign exchange, where the mutual deliveries fall due for payment or delivery on the same day"[25].

The content of legal risk will comprehend in some extent the possibility in each jurisdiction to apply the already explained types of set-off and netting. Therefore, the insolvency law in each country usually contents rules regarding the topic. Otherwise, the scope of the ISDA master agreement in terms of these legal figures would be limited. The question to be solved in the forthcoming regulatory changes is to whether this mechanism shall be allowed in all jurisdictions; as part of the effectiveness of the new documentation issued by ISDA.

On the other hand, in terms of risk management it is important to understand that ISDA documentation will continue to play a central role in clear as well as uncleared derivatives. Therefore, the aim to provide legal certainty through standardization will continue being important. Also the netting because the use of standard agreements improves the efficacy of netting, enjoys the benefit of formal legal opinions from the major jurisdictions and receives the approval of regulators for this purpose.

Even facing of all the changes in the derivatives world, the well-known advantages of the use of standard agreements as ISDA Master Agreement[26] continue to make the market attractive. The main role is to provide legal safety[27] and the confidence and predictability[28] of the transactions done following the internationally accepted standards. The massive saving of

[24] Ibid.
[25] Ibid. P, 219
[26] The ISDA master agreement is the most commonly used master contract for OTC derivative transactions internationally. It is part of a framework of documents, designed to enable OTC derivatives to be documented fully and flexibly. The framework consists of a master agreement, a schedule, confirmations, definition booklets, and a credit support annex. The ISDA master agreement is published by the International Swaps and Derivatives Association.

[27] The parties involved will exactly know the rules that govern the contractual relationship.

[28] Predictability indicates these types of contractual forms are recognised by international courts. Therefore, the resolution of disputes will be easier for judges. Courts are not likely to dismiss the content of these instruments.

time compared to documenting each transaction separately enhances the fast-moving markets.

The study of the current research deals with the use of the ISDA master agreement to reduce the legal[29] and the counterparty credit risk[30]. The analysis referred to different types of derivatives as are: futures, options, swaps and similar transactions. Regarding the legal risk the benefits are: the industry acceptance of standard terms leads to greater chance of accepted meanings adopted in courts; automatically cover deals without the need to enter into new contract; and the provision of cross-product netting, it is if a counterparty defaults on one transaction, netting will occur across all the transaction involving the same parties.

Despite the abovementioned merits of the use of ISDA master agreement to deal with legal and credit risk; there are still some challenges to face. For instance in the case of the United States regulatory advances[31], the current ISDA documentation requires responses. Some of the changes proposed include reforms on business conduct standards, to enforce the knowledge of your counterparty; confidential treatment of counterparty information; higher levels of disclosure. Also in the fields of swap trading relationship documentation, collateral segregation; collateral dispute resolution, swaps executions facilities issues and to clarify the topic of extraterritoriality, among others.

Regarding the enhancement of central counterparty clearing system; the assessment is focused on the policy of having common rules for clearing and clearing houses. Under the rationale that more derivative instruments become standardised and in this way subject to clearance. However, the market indicates that we will continue to see tailored transactions

[29] Legal risk is risk from uncertainty due to legal actions or uncertainty in the applicability or interpretation of contracts, laws or regulations. Depending on an institution's circumstances, legal risk may entail such issues as: Contract Formation and Capacity. Definition consulted on http://www.riskglossary.com

[30] Counterparty Credit risk is risk due to uncertainty in a counterparty's (also called an obligor's or credit's) ability to meet its obligations. Because there are many types of counterparties—from individuals to sovereign governments—and many different types of obligations—from auto loans to derivatives transactions—credit risk takes many forms. Definition consulted on http://www.riskglossary.com

[31] Dodd–Frank Wall Street Reform and Consumer Protection Act. July 21 2010.

and even more than in the last decades of the OTC derivatives markets. In this regard, the position of the regulators to lower the clearing member requirement is not fully accepted as the appropriate response to the market needs.

The Central Counterparty Clearing System (CCPs)[32], is being thought for the OTC derivatives in order to guarantee the operational capability as well as a system of reduction of counterparty credit risk. The system consists on a clearing house that is going to be an intermediate between investors and clearing members. The house is not only a cannel but also a "central part" that would support the potential default of both, members and investors. Undoubtedly, clearing system is set to avoid the domino consequences of default.

The two main functions of the clearing systems are: market risk management[33] and asset management[34]. That is why within its regulation the core aspects are the maintenance of transparency and performance rules and a well-established default management process.

The research we will develop through this and subsequent articles will analyse the impact of the policies implemented and its effectiveness. Also to review the clearing membership

[32] "Clearing: After the execution of buy and sell orders, transactions are processed in preparation for the transfer of ownership of the product and the fulfilment of all obligations. Depending on the institution providing this service, several additional services are performed, such as the netting of obligations to ensure fewer processes and cash flows, and in particular the evaluation and management of all relevant sources of risk in order to reduce the probability of failure to meet obligations. In most cases, this function is performed on different levels; firstly by trading parties for their clients, secondly at central counterparty clearing houses (CCP Clearing) and thirdly at central security depositories (CSD/ICSD Clearing) or banking institutions (for internal executions) for public market participants." http://ec.europa.eu/internal_market/financial-markets/docs/clearing/2004-consultation/each-annex3_en.pdf

[33] "Risk management is the process of identifying, quantifying, and managing the risks that an organisation faces. As the outcomes of business activities are uncertain, they are said to have some element of risk. These risks include strategic failures, operational failures, financial failures, market disruptions, environmental disasters, and regulatory violations. While it is impossible that companies remove all risk from the organisation, it is important that they properly understand and manage the risks that they are willing to accept in the context of the overall corporate strategy. The management of the company is primarily responsible for risk management, but the board of directors, internal auditor, external auditor, and general counsel also play critical roles". Definition available in http://lexicon.ft.com/Term?term=risk-management

[34] "Asset management, broadly defined, refers to any system whereby things that are of value to an entity or group are monitored and maintained. It may apply to both tangible assets and to intangible concepts such as intellectual property and goodwill. Asset management is a systematic process of operating , maintaining, and upgrading assets cost-effectively". Definition available in http:/lexicon.ft.com/Term?=asset-management

requirements that have been agreed by the actors of the market: 1) The capital required to each member shall be enough to comply with its own obligations with clients but also to assume other members default, in the case of contingency liability; 2) The risk management marking the portfolio on a daily basis and managing eventual defaults of clients; 3) The operational capability.

Moreover, the monitoring of the CCP by members requires the enhancement of the transparency and performance rules and an effective supervision by securities regulators and central banks. There is also the need of an international agreement as to which products are "clearing eligible"[35] and how the inherent risk of the product can or cannot be mitigated by the CCP. Once the eligible products have been cleared identified, the abovementioned monitoring process will take place.

However, effective mechanisms to mitigate the counterparty risk should be considered for cleared and non-cleared products[36]. For those products which are not centrally cleared these should be subject to strong bilateral collateralisation arrangements and appropriate risk capital requirements. In both cases, all participants should bear the costs of managing the risk each product poses[37].

[35] Financial Stability Paper No. 14 – March 2012. Thoughts on determining central clearing eligibility of OTC derivatives: "Work done by the FSB and by IOSCO sets out the general framework for determining the clearing obligation Specifically, the FSB (2010) identifies the following broad factors that should inform the process of establishing a clearing obligation:
• the degree of standardisation of a product's contractual terms and operational processes;
• the nature, depth and liquidity of the market for the product in question; and
• the availability of fair, reliable and generally accepted pricing sources.

EMIR also specifies that in its technical standards, the European Securities and
Markets Authority (ESMA) takes into account additional factors related to the CCP's ability to clear new contracts. A recent consultation paper published by ESMA (2012) proposes the following additional considerations:
• contractual standardisation terms need to refer to common legal documentation, including master netting agreements;
• margins need to be proportionate to the historical stability of liquidity, and liquidity needs to be sufficient in case of a default of a clearing member; and
• pricing information needs to be readily available to participants."

[36] Shares traded directly between brokers, and not cleared through the stock exchange clearing house.
[37] Reforming the OTC derivatives market a UK Perspective. Financial Service Authority &HM Treasury. December, 2009. P. 12

3. Derivatives and International Swaps and Derivatives Association

To refer the work carried on by ISDA International Swaps and Derivatives Association, the Master Agreement is one of the meaningful instruments. The three main tasks given to ISDA since it was created[38] are: 1) the management of credit risk; 2) increase of transparency and 3) Operative infrastructure industry improvement. Therefore, the structure of the documents issued and updated by ISDA answer to this rationale.

Indeed, the ISDA Master Agreement is structured upon the basis to provide protection and certainty to the parties involved in derivatives transactions.

Different definitions have been proposed to Derivatives as financial instruments to manage risk and alternative way of financing. Hudson set out these definitions:

> *"Derivative is simply, a financial arrangement the value of which is "derived" from another financial instrument, index or measure of economic value.*
> *(...) Financial arrangement involving mutuality and valued by reference to current market rates, prices or levels.*
> *(...)Is a contract in which the parties only pretend to do something and allocate the risks and benefits between themselves as if they had done that something"*[39]

Indeed, derivatives can be characterised as wholesale market instruments and counter-intuitive tools, since they are contrary to what might be expected. However, the lack of certainty of these instruments has been gradually seen by regulators.

The Derivatives market is divided into two schemes the stock exchanges and the OTC Over the counter market[40]. In the case of the stock exchanges the control of derivatives transactions is set out by the institution itself. It is the stock exchange usually has some rules

[38] ISDA International Swaps and Derivatives Association was set out in 1985 Since its the International Swaps and Derivatives Association has worked to make over-the-counter (OTC) derivatives markets safe and efficient. http://www2.isda.org/about-isda/
[39] A. Hudson ed., Credit Derivatives: law, regulation and accounting issues. Sweet and Maxwell, 1999. P. 63

[40] Ibid. p. 48

to govern the transactions, actors and transparency requirements to be fulfilled. That is why some of the issues related in the first part of this article are well managed by those internal regimes.

Some of the advantages of stock exchange derivatives market are aspects as the liquidity and price transparency. Liquidity is increased since the contract is more easily saleable because the contracts are standardised. However, something similar happens in OTC due to the use of contract forms as the ISDA Master Agreement. Also the Price Transparency, the exchanges must usually publish the price of trades immediately. As a result, the price is likely to be close to market price. On the contrary, in the OTC market there are only indicative prices.

Additionally, the OTC Derivatives Market presents some additional concerns regarding the rules applicable to market actors and transactions. Traditionally, OTC markets are private transactions[41]. These deals are usually sold by banks. Indeed, its name comes from describing the practice of buying shares over bank counters. Consequently, the rules are set by the same actors of the market and their commonly accepted practices[42]. What triggers the policies currently being implemented in international markets, sufficiently illustrated in the first part of this article.

Within this scheme, the current article is strictly limited to the study of ISDA Master Agreement. This is a contract model implemented in the OTC Derivatives Market. It is commonly used in most of the international OTC transactions. However, before going in to the details of its composition, we will do a quick reference to the main derivatives transactions.

4. Most commonly used Derivative Transactions

It is important to clarify that each transaction must response to a derivate type to be called financial derivative. It is if a loan is documented under ISDA derivatives agreement, it does not automatically transform the instrument into a derivative. Ergo, the real effect of the

[41] E, Green, U.S. Regulation of the international securities and derivatives markets. New York: Aspen Law & Business, 2002.p.21
[42] Ibid. p. 19

transaction is the key feature to determine whether we are or not in front of a derivative transaction. Here the reason to explain the main types of derivatives: options, futures and swaps.

A) Options:

Options can be divided into two the option to sell and the option to buy. Basically they refer to the transaction according to which one person buys the right to sell or to buy a specific thing, establishing a future date to deliver it but fixing the price in the moment of the transaction[43]. The negotiation lies on the right to buy or sell but not over the thing, usually commodities. There is an inherent risk involved in this type of transactions, the variation of the real price[44] of the things. Thus, if the price of the thing is higher by the delivery date, the seller is losing the difference while the buyer is gaining it. On the contrary, if the price of the thing is lower by the delivery date than the one initially fixed, the seller is profiting from the transaction while the buyer is losing the difference. This part of the transaction makes some authors[45] to characterised derivatives as contracts for differences.

The second element of options to buy or to sell is the possibility to withdraw the right[46]. It is that the motive for the transaction does not exist anymore by the time of the delivery date. In this case, as the negotiation was over the right to sell or to buy, the withdrawal does not affect the trading of the commodities at all. They can be negotiated freely without producing any event of default.

B) Futures or Forwards

Different are the risks involved in the so called Futures or Forwards. These instruments are different from options because the object is not the right to buy and sell but the things themselves. Thus, one party agrees with another to sell specific things in a future date at a fixed price[47]. No matters whether the real price the things have by the fixed date; the price will be fixed and paid by the time parties enter into the transaction. This is a very useful

[43] J, Hull, Options, futures &other derivatives. Prentice Hall International, 2003. P.194

[44] The real price is the market price.
[45] Ibid. p.176
[46] A. Hudson. Op.cit. p.93
[47] J, Hull. Op.Cit. p. 104

instrument of financing and those sources could be used immediately by the "seller". As can be noted, the potential risk of counterparty default is the basis of a successful or failed transaction.

C) Swaps

As this and all the others financial system transactions are surrounded by the potential counterparty default, the next type of derivatives is the most commonly used. They are the swaps. Under the swaps the structure of the transaction considerably varies from the two previous types explained. The basic swap is made upon the basis to set off the object of the transaction. That is why it is better understood with an example.

Company A and Company B has borrowed 100 of third parties. The credit taken by Company A was agreed with a variable interest rate (eg LIBOR) plus 1%. The credit of B Company in the form of bond has a fixed rate of 10%.

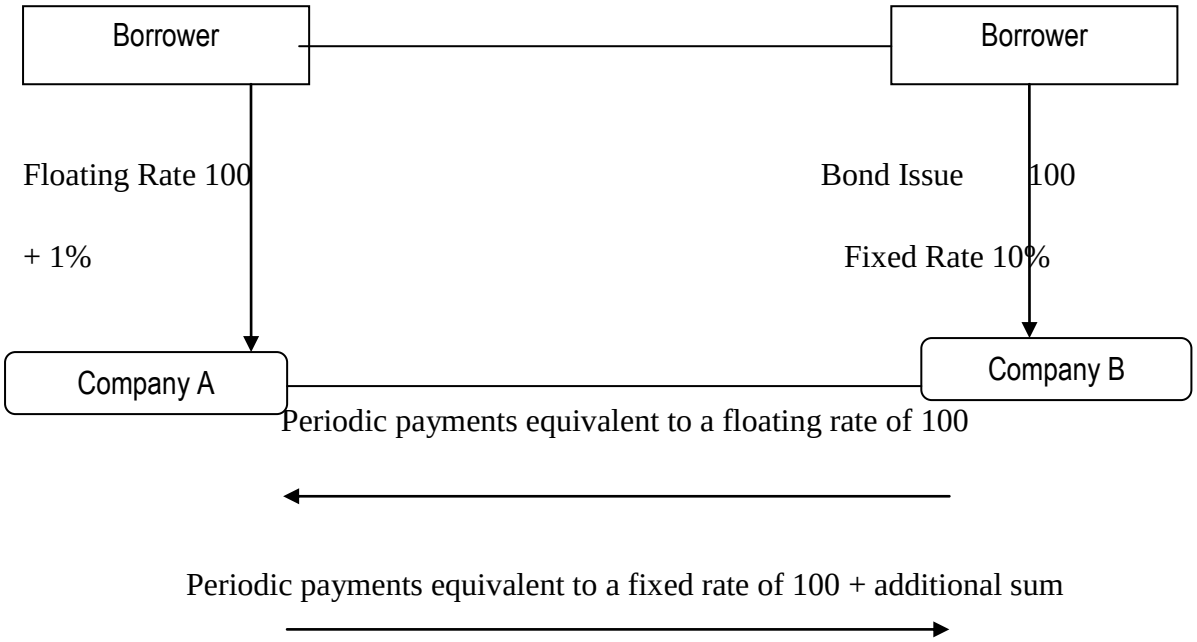
Under this assumption in fact the interest rate swap payments are as follows: Company B pays Company A periodic amounts equal to the variable interest rate of 100. Company A Company B pays periodic amounts to a fixed interest rate of 100 plus an additional amount representing the profit of the company B. Payments will agree to a specific date in a way that can be compensated.

The economic rationale of a transaction in this regard is that Company A is a bank that can lend money at a fixed rate, while Company B has less creditworthy and therefore goes to the bond issue.

Reciprocal payments are not self-interest but sums equal to interest calculated on a single principal sum, which for example is 100.

The creditors of Company A and Company B will not be affected, as they have to comply with the payment of its obligations thereunder regardless of whether the payments within the structure of the swap are made or not. So if Company B becomes insolvent, Company A must also pay the rate of 10% to the bondholders and is not receiving payments from Company B.

Basic Structure of Interest Rate Swap



The counterparty risk is usually collateralised with what is known as "mirror transaction". Its name is quite illustrative since it is a similar transaction to hedge the risks involved in the primary transaction. From this perspective, derivatives are usually explained as buy or sell of protection, with a similar function to insurance.

The use of Interest Rate Swaps requires us to make a reference to compression concept. It is a risk reduction practice that "enables swap dealers with substantial two-way (pay and receive) swap activity to terminate substantial amounts of swap contracts before they expire by their terms. The benefits of compression include reductions in counterparty credit exposure, operational risk and cost, as well as lower legal and administrative expenses in the event of a default of any participating dealer. Importantly, since contracts are actually eliminated, under some regimes capital costs can be reduced. Together with expanded clearing of IRS, compression produces tremendous reduction of risk in the derivatives marketplace"[48].

[48] Interest Rate Swaps Compression: A Progress Report. ISDA Study, February 2012

D) Credit Default Swaps (CDS)[49]

According to this transaction a seller of protection, called the guarantor, agrees to pay to the buyer of protection (the creditor) an amount if during and agreed period a prescribed *credit event*[50] occurs signifying a problem in relation to a reference obligation (the guaranteed debt) of a reference entity, the principal debtor. Basically, it works as a guarantee and the instrument will be enforced only when the underlying obligation is in default, that is called *credit event.*

5. ISDA Master agreement structure: dealing with legal risk

The Documentation of ISDA Master Agreement[51] provides the possibility to have the same basis for all the transactions instrumentalised with it. Even though each transaction has particularities the attachment of standardised conditions helps to provide legal certainty. The parties involved in the transaction will be open to consider some fundamental structures and combine them with their own interests.

As a standard documentation it is in the option of the parties to adopt it completely or partially. Indeed, the adoption could be partial allowing the parties to draft the transaction suitable to the individual needs. Also the complete adoption could be accompanied by additional clauses specially tailored to the transaction.

The structure of the ISDA Master Agreement is divided into two parts: the recital and the schedule. The recital contents all the rules about interpretation, obligations, representations,

[49] "A swap designed to transfer the credit exposure of fixed income products between parties. A credit default swap is also referred to as a credit derivative contract, where the purchaser of the swap makes payments up until the maturity date of a contract. Payments are made to the seller of the swap. In return, the seller agrees to pay off a third party debt if this party defaults on the loan. A CDS is considered insurance against non-payment. A buyer of a CDS might be speculating on the possibility that the third party will indeed default." R, Gengatharen, Derivatives law and regulation (Kluwer Law International, 2001. P.59

[50] Usually a credit event includes: bankruptcy, insolvency restructuring or rating downgrade.

[51] Regarding the application of ISDA Master Agreement in a recent case: "ISDA's General Counsel, David Geen, said: "We are delighted, but not surprised, that the Court of Appeal has really understood the meaning and purpose of the key provisions of the ISDA Master Agreement and has unambiguously affirmed the positions that ISDA has consistently held. This judgment provides clarity and certainty to the derivatives market and vindicates ISDA's decision to participate in the appeals". The International Swaps and Derivatives Association, Inc. (ISDA) welcomes the Court of Appeal's judgment handed down today in the appeal case of Lomas and others v JFB Firth Rixson, Inc and others. Available on http://www2.isda.org/news/isda-welcomes-the-english-court-of-appeals-decision-to-uphold-isda-master-agreement-in-lbie-judgment

agreements, events of default and termination events, early termination and close-out netting and miscellaneous.

A) The Recital

This is the statement that establishes *"all the transactions between the parties are governed by this master agreement"*. As a result, the first general agreement between the same parties will automatically cover all the subsequent transactions. Indeed, this is the first tool to manage the legal risk. We are not only avoiding instrumentalising each time each transaction, but also providing the rules applicable to all of them. This character is restated by the interpretation clause:

"This master and all transactions under it are a single agreement"[52]

Then, the ISDA Master Agreement refers to the obligations of the parties. Some of the general standards include in these clauses[53] are:

- Each party will pay or deliver as specified in each confirmation, but only if there has been no (potential) event of default or election to terminate.
- A party may change its payment or delivery account by notice subject to reasonable objection by the other.
- Payments in the same currency under the same transaction falling due on the same day will be netted.
- Each party will gross up for taxes which must be deducted from payments, subject to conditions.

The Representations[54] section, sets out each party gives representations as to its status, powers, non conflict with laws, constitution or contracts, official consents obtained, legal

[52] ISDA Master Agreement Version 2002
[53] Ibid
[54] *Representations and Warranties* is a common law concept that includes a serie of obligations and statements that are true by the time of the contract. They also determine the duration and validity. Each time the contract is

validity, no potential events of default or termination event, no material litigation, tax representations correct and no agency.

Different are the agreements where each party will furnish the agreed information, maintain authorisations, comply with laws, notify the other it its tax representation becomes untrue and pay stamp taxes.

It is also important to include the Events of default and termination events clause. The content of the clause will usually include: failure to pay or deliver; breach or repudiation of agreement; default in relation to credit support; material misrepresentation; default in derivative transactions (cross default)[55];bankruptcy and merger without the new entity assuming the obligations under the master agreement[56].

The events of termination that not necessarily involve defaults but nevertheless justify in terminating are: the illegality; force majeure[57]; change of tax law resulting in tax grossing up[58]; merger resulting in tax grossing up[59]; and the merger, change of control[60] or debt incurrence.

On the other hand, there is a specific provision of early termination and close-out netting. According to this provision if an event of default or termination event occurs in relation to one party, the other party may terminate. The relevant party (non in default) calculates the

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updated these conditions shall be fulfilled. Some examples are the credit worthiness, constitution of companies, powers of directors. McKnight, Andrew. The Law of International Finance. Oxford University Press, 2008. P. 492

[55] LMA 2004: "22.5 Cross Default (a) Any financial indebtedness of any member of the group is not paid when due nor within any originally applicable grace period. (b) Any Financial Indebtedness of any member of the Group is declared to be or otherwise becomes due and payable prior to its specified maturity as a result of an event of default (however described). (c) Any commitment for any Financial Indebtedness of any member of the Group is cancelled or suspended by a creditor of any member of the group as a result of an event of default. (d) Ay creditor of any member of the Group becomes entitled to declare any Financial Indebtedness of any member of the group due and payable prior to its specified maturity as a result of an event od default. (e) No Event of Default will occur under the Clause 22.5 if the aggregate amount of Financial Idebtedeness falling within paragraphs (a) to (d) above is less than____."

[56] It is called "Merger without assumption"
[57] One common example of force majeure is the market disruption.
[58] It is called "Tax Event"
[59] It is called "Tax event upon merger"
[60] The clause provides in outline: The borrower will not (will procure that each of its subsidiaries will not) dispose of all or a substantial part of its respective assets (by one or a series of transactions, related or not). Wood, Philip. Law and Practice of International Finance. Sweet and Maxwell, 2008. p.120

losses and gains on each transaction and set them off[61]. A non-defaulter has a right to set off other non-agreement sums. In the case of transfer, neither party can transfer its rights or obligations without the consent of the other.

B) *The Schedule*

The schedule includes adaptations to events of default and termination, tax representations, documents to be provided and other agreed modifications.

In summary, the structure of the ISDA Master Agreement set out a series of obligations and commitments to the parties of the transaction. It establishes some protection regarding the exposure to credit events or events of default. The Master is the framework to provide legal certainty and predictability. Indeed, the three main characteristics recognised as advantages of the use of international standards are:

- Industry acceptance of standard terms leads to greater chance of meanings being accepted in court.
- Automatically cover deals without the need for fresh contract, thus more likely that an agreement will be in place.
- Provides for cross-product netting so if counterparty defaults on one transaction, netting will occur across all the transactions involving the same parties.

However, there are still some pending topics that cannot be covered by the ISDA Master Agreement. These issues are usually let to national regulation. Among other topics, they are: the Capacity[62] and authority of each party as principal or as agent in each transaction. The legal requirement of contract formation and enforceability; liability arising from trading: negligence, deceit, misrepresentation, breach of contract. Some regulatory issues as licensing and other governmental consents/approvals, marketing restrictions, conduct of business rules and prudential supervision and regulatory capital.

[61] This is the proceeding of close-out netting.
[62] Regulatory restrictions may also limit the capacity of some institutions to enter into certain types of derivatives contracts. *Hazell v. Hammersmith and Fullham London Borough Council (1992).* Interest rate swaps were held to be ultra vires UK local authorities and therefore void.

Special mention deserves the case of Gambling Act 1845 in the United Kingdom. This Act established that contracts for differences and swaps may be deemed to be gambling contracts which were void under gambling laws. Consequently, some jurisdictions introduced exceptions to gambling laws in order to facilitate and to remove the threat of nullity. In the UK the new regulation is contained on the Gambling Act 2005.

Another legal risk is that the derivatives came under the ambit of insurance regulation. Although derivatives are similar in their function to provide protection, the general consensus is that they are different to insurances. The rationale to confirm the existent differences is that derivatives dealers are not within the remedial purpose of legislation, as the insurance brokers are. The regulation applicable is given by banking and financial services sector; and finally that a dual authorisation as insurers would cause duplication.

Within this framework the management of the legal and credit risk requires mainly two stages. The first face is to understand the counterparty, to establish the nature of my relationship with him and the nature of the counterparty. This part requires me to have a legal opinion about: legal capacity and authority; special regulatory regime; special insolvency regime; regulatory classification and statutory liability; among other specifics of the case.

The second stage is to use the Documentation to manage the risks: mainly through a very careful drafting, checking and matching of trade confirmations. Especially the review of key provisions of the ISDA Master Agreement addressing legal risk issues. These key provisions are the representations and agreements, as well as typical closing documents[63]. The representations and agreements altogether with events of default, termination and close-out netting provide the tools to manage counterparty credit risk.

[63] Evidence of capacity and corporate authority, evidence of signing authority and legal opinión in certain circumstances.

Conclusion

Derivatives Market is divided into two parts: derivatives traded in exchange and the Over the Counter Market. The exchanged traded derivatives are usually governed by special rules set on the particular stock exchange. On the contrary, the OTC derivatives are "ruled" by the actors of the market. Therefore, topics as transparency, netting, risk management, clearing systems are specially concern for the OTC products.

Since derivatives market is on international scale, one of the options to rule in a similar way has been the standardisation of contracts, we refer to OTC market. The reason of standardisation is given by the fact; ISDA International Swaps and Derivatives Association gathers the market participants and is the forum to discuss market practices.

The main types of financial derivatives: options, futures or forwards, swaps and Credit Default Swaps. Options defined as the transaction according to which one person buys the right to sell or to buy a specific thing, establishing a future date to deliver it but fixing the price in the moment of the transaction. Futures or Forwards where one party agrees with another to sell specific things in a future date at a fixed price. Swaps made upon the basis to set off the object of the transaction. *Credit Default Swaps (CDS),* according to this transaction a seller of protection, called the guarantor, agrees to pay to the buyer of protection (the creditor) an amount if during and agreed period a prescribed *credit event* occurs signifying a problem in relation to a reference obligation (the guaranteed debt) of a reference entity, the principal debtor.

ISDA International Swaps and Derivatives Association, issues one of the meaningful instruments, the ISDA Master Agreement. The three main tasks given to ISDA since it was created are: 1) the management of credit risk; 2) increase of transparency and 3) Operative infrastructure industry improvement. Therefore, the structure of the documents issued and updated by ISDA answer to this rationale.

The three main characteristics recognised as advantages of the use of international standards are:

- Industry acceptance of standard terms leads to greater chance of meanings being accepted in court.

- Automatically cover deals without the need for fresh contract, thus more likely that an agreement will be in place.

- Provides for cross-product netting so if counterparty defaults on one transaction, netting will occur across all the transactions involving the same parties.

However, there are still some pending topics that cannot be covered by the ISDA Master Agreement. These issues are usually let to national regulation. Some other aspects are pending to be solved by regulators will be topic of subsequent research articles within the framework of this research.

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