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AN INTRODUCTION TO THE DOCUMENTATION OF OTC DERIVATIVES

"TEN THEMES"

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The Ten Themes:

- **ISDA's Mission**
- **Master Agreement**
- **Schedule**
- **Confirmations**
- **Definitions**
- **Netting**
- **Collateral/credit support**
- **Opinions**
- **User's Guides**
- **Protocol**

1. ISDA's Mission

ISDA's primary purpose is to encourage the prudent and efficient development of the privately negotiated (or "over-the-counter" (OTC)) derivatives business by, among other things:

- Promoting practices conducive to the efficient conduct of the business, *including the development and maintenance of derivatives documentation*; and
- Promoting the development of sound risk management practices.

ISDA was formed in 1985, after a group of 18 swap dealers and their counsel began work in 1984 to develop standard terms for interest rate swaps.

2. Master Agreement

Market participants that enter into OTC derivatives transactions could, as they used to, document each transaction in a separate, comprehensive agreement. Such an agreement, being independent from any other agreement between them, would necessarily be lengthy. It would not merely set forth the economic terms of the relevant transaction, but would also include terms relating to the general legal and credit relationship between the parties. These types of terms, in addition to the economic terms of the transaction, would have to be negotiated each time the parties entered into a transaction.

It would clearly be far more efficient if the parties could agree upon these "relationship" terms once and for all, so, each time they entered into a transaction, they would only have to negotiate and document the economic terms of the transaction. The parties could achieve this by entering into a framework "master agreement" that sets the ongoing legal and credit relationship between them, and provides that each transaction they enter into will be governed by that master agreement. It would be even more efficient if the parties could document a range of different *types* of transactions under the same master agreement, rather than having to enter into a separate master agreement for each type of transaction.

The ISDA Master Agreement offers participants in the OTC derivatives markets all of these benefits. When two parties negotiate and sign an ISDA Master Agreement, they agree upon the ongoing legal and credit relationship between them. While they can, of course, agree to amend the terms of their agreement at any time, there is no need to negotiate a whole host of issues each time they enter into a new transaction. Also, unlike many other financial master agreements, the ISDA Master Agreement can be used to document a range of different types of transactions (it is "multi-product").

The most widely used agreement in the OTC derivatives markets is currently the 1992 ISDA Master Agreement (Multicurrency-Cross Border).

3. Schedule

A key feature of ISDA's documentation is its "modular architecture". ISDA has published a number of different documents, with a variety of purposes. Essentially, market participants are provided with a number of "building blocks" that they can use as they see fit, and in a highly efficient and flexible manner. This architecture is evident in the structure of the ISDA Master Agreement itself. It consists of two parts: the printed form and the Schedule.

- The printed form makes up the first 18 pages of the agreement. The intention is that parties signing an ISDA Master Agreement do not physically amend the printed form on the agreement itself.
- The Schedule is the part of the agreement that the parties negotiate. It allows the parties to make certain choices, to amend provisions contained in the printed form, and to include any appropriate additional provisions. One of the key choices the parties make in the Schedule is whether the agreement should be governed by the laws of New York state or the laws of England (it is designed to be governed by either).

4. Confirmations

As described above, if two market participants have entered into an ISDA Master Agreement, then, each time they enter into a transaction, they only have to negotiate and document the economic terms of the transaction. Confirmations are the documents in which the parties record those economic terms.

The ISDA Master Agreement itself provides that the agreement includes the Schedule and the documents and other confirming evidence (each a "Confirmation") exchanged between the parties confirming individual transactions. Further, each Confirmation is identified (or should be identified) either in its own terms or through another effective means as a "Confirmation", and states that it supplements, forms a part of, and is subject to, the ISDA Master Agreement between the parties. In this way, the provisions of the agreement govern transactions documented in Confirmations.

The use of Confirmations to document the economic terms of transactions again illustrates the modular architecture of ISDA documentation.

Confirmations come in two forms: long-form and short-form.

- Long-form: a long-form Confirmation itself contains, in full, all the terms necessary to document the economic terms of the transaction.
- Short-form: a short-form Confirmation does not contain all the terms necessary to document the economic terms of the transaction. It relies on, and incorporates, standard terms and provisions that are already contained in another document (or documents), such as a set of ISDA Definitions (see below). This enables the use of shorthand terms in the Confirmation, and avoids the need to set out in full various operational provisions. The terms and provisions contained in that other document should broadly reflect market practice. Therefore, completing a short-form Confirmation should be a quicker task than completing a long-form Confirmation.

Why the distinction? In the past, when a market in a new type of derivatives transaction has developed, ISDA has traditionally published a long-form Confirmation for use in documenting that type of transaction (for example, one long-form Confirmation that is still frequently mentioned, although now superseded, is the 1997 Confirmation of OTC Credit Swap Transaction, prepared for use in documenting a credit default swap, which at the time was a relatively new type of transaction). Then, when a new market has matured, and a consensus has developed among those active in that market, ISDA has traditionally prepared a set of Definitions, together with one or more short-form Confirmations. Until the market has matured and that consensus has developed, it would probably not be productive to try to prepare a standard set of Definitions.

5. Definitions

When used in the ISDA sense, "Definitions" are the various booklets of standard definitions and other terms and provisions published by ISDA for use in documenting different types of derivatives transactions. Generally, and broadly, each set of Definitions provides relevant terms for documenting a particular type of derivatives transaction. For example, the 1993 Commodity Derivatives Definitions are intended for use in documenting cash-settled commodity derivatives, the 1996 Equity Derivatives Definitions are intended for use in documenting equity derivatives, and the 1999 Credit Derivatives Definitions are intended for use in documenting credit default swaps. Even the 2000 Definitions, unlike their predecessors (the 1991 Definitions), are drafted primarily for use in documenting particular types of derivatives transactions: interest rate and currency derivatives.

As described above, short-form Confirmations rely on Definitions. They do this by stating that they incorporate a particular set (or sets) of Definitions. However, while they do a lot of the work for the parties, ISDA Definitions do not take care of everything. The Definitions themselves only provide a framework for documenting a transaction. It is still up to the parties to make various choices and to document the economic terms of the transaction itself in the short-form Confirmation.

The parties are also free, of course, to amend the terms of the relevant Definitions or include additional provisions in the short-form Confirmation itself. While the terms of the Definitions represent the result of an extensive industry consultation process, they will not be appropriate for documenting all transactions without amendment or additional provisions.

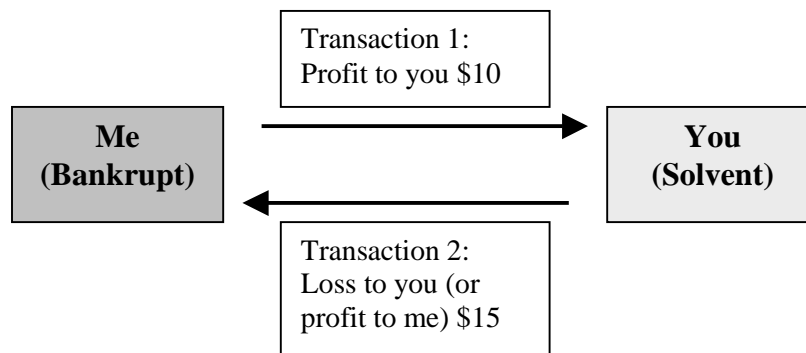
Unlike ISDA's sample long-form Confirmations, which are published as standalone documents, ISDA's sample short-form Confirmations are published as part of a set of Definitions. So, if someone is looking for ISDA's sample short-form Confirmation for an equity swap, they will find it at the back of the 1996 Equity Derivatives Definitions.

6. Netting

When people in the ISDA world talk about "netting", they generally mean "close-out netting".

If you and I have two outstanding derivatives transactions between us, at any time one may be profitable to you; the other may be profitable to me. Suppose, before the days arrive when we each (assuming satisfaction of all applicable conditions) have to make payments (for example) to the other, I become bankrupt.

Example:



The danger for you is that my liquidator/bankruptcy trustee, applying the laws of my jurisdiction, will "cherry pick" profitable transactions and disclaim unprofitable transactions, or try to require you to pay me \$15 in respect of Transaction 2, while trying to avoid an obligation for me to pay you \$10 in respect of Transaction 1. If my liquidator/bankruptcy trustee is successful, you will have to pay my "estate" \$15, and join the line of other creditors trying to claim money (in your case, \$10) against my estate. Almost inevitably, you will ultimately receive only a tiny fraction of \$10, if anything (I am bankrupt).

However, if you can cancel both transactions upon my bankruptcy, and "net" the above values, or reduce your obligation to pay me to the net amount of just \$5 ($\$15 - \10), you will be much better off. In this way, close-out netting, if you can do it, reduces your "exposure", or "credit risk" - i.e., the amount you could lose in these circumstances.

The ISDA Master Agreement provides for such close-out netting. Ensuring the enforceability of the close-out netting provisions of the agreement has been, and remains, a key initiative of ISDA, because of its importance in reducing the credit risk arising from the OTC derivatives business. Close-out netting is viewed by regulators as a means to limit "systemic risk", so banks are rewarded for having legally enforceable netting agreements by the reduction of the amount of capital they need to keep in reserves. However, in many jurisdictions, legal opinions in support of close-out netting are necessary to obtain this benefit. Because of this, and because not all jurisdictions recognise the enforceability of close-out netting, ISDA collects netting opinions (see "Opinions" below).

7. Collateral/credit support

Another way that market participants can reduce their credit risk, or risk of loss if their counterparties fail to perform their obligations, is through the use of collateral (alternatively known as credit support, or margin). In the example above, assuming that we are both solvent, even if close-out netting is enforceable I still have a net exposure to you of \$5. In other words, if you fail to perform your obligations, even if I can apply close-out netting, you will owe me \$5. If we had agreed to "collateralise" our relationship, in a perfect world you would have provided me with collateral (such as government bonds) worth \$5. The idea is that if you fail to perform your obligations, I can keep the collateral worth \$5. In this way, I am not at risk of losing anything. My credit risk has (basically) been eliminated.

It might be helpful to compare this situation to a residential mortgage. If a bank lends a homebuyer the money to buy a house, the homebuyer gives the bank a mortgage. The mortgage entitles the bank, if the homebuyer does not make his or her mortgage payments to the bank, to sell the house and keep the proceeds to settle the debt owed to it by the homebuyer.

Participants in the OTC derivatives markets do not always collateralise their relationships, but they are increasingly doing so.

Collateral relationships in the OTC derivatives markets are currently typically documented under one of the following documents:

- 1994 Credit Support Annex (Bilateral Form) - New York law
- 1995 Credit Support Annex (Bilateral Form - Transfer) - English law
- 1995 Credit Support Deed (Bilateral Form - Security Interest) - English law
- 1995 Credit Support Annex (Bilateral Form - Loan and Pledge) - Japanese law

Note, however, that ISDA recently published the 2001 ISDA Margin Provisions, which are intended to replace the above documents, and which it is hoped will be used more and more in the future. All these documents are commonly referred to as ISDA's "credit support documents".

8. Opinions

One of the main benefits ISDA gives to its members is access to the "legal opinions" it has gathered (only ISDA members may rely upon ISDA's legal opinions).

A legal opinion is a document in which a lawyer gives his or her understanding of (or opinion on) the law of a legal jurisdiction as applied to certain assumed facts. For example, where there is a contract between an English company and a French company, and that contract is governed by English law, an English lawyer might give a legal opinion to the French company in which he or she would consider whether the French company would be able to enforce the contract against the English company. Although the legal opinion would only give the English lawyer's *opinion*, it might give the French company some comfort.

In the ISDA world, "opinions" mean either netting opinions or collateral opinions.

- Netting opinions: ISDA has collected netting opinions from lawyers (or "counsel") in 36 jurisdictions around the world. In the netting opinions, counsel considers whether the close-out netting provisions contained in the ISDA Master Agreement would be enforceable by a party against a range of types of entities organised or incorporated in the jurisdiction of counsel's practice.

- Collateral opinions: ISDA has collected collateral opinions from counsel in 28 jurisdictions. In the collateral opinions, counsel considers whether the provisions contained in ISDA's credit support documents would be enforceable by a party against a range of types of entities organised or incorporated in the jurisdiction of counsel's practice.

If the ISDA Master Agreement is only designed to be governed by either New York law or English law, why do people care about the laws of other jurisdictions? If a party becomes insolvent, the insolvency laws of the jurisdiction in which it is organised or incorporated will typically apply. If the insolvent party is incorporated in Country X, for example, although the agreement itself is governed by English law, and the solvent party is an English company, the insolvency laws of Country X will typically apply.

As noted above, regulators require legal opinions in support of close-out netting if they are to recognise close-out netting for banks' capital purposes. In addition, they require these legal opinions to be updated annually.

ISDA typically gathers updated netting opinions in November and December of each year, and releases them to ISDA members in the following January. Until now, collateral opinions have not been updated annually, but ISDA has signalled an intention to update the collateral opinions regularly in future.

9. User's Guides

User's Guides are documents published by ISDA to assist market participants' understanding of ISDA documentation. The most well-known User's Guide is the User's Guide to the 1992 ISDA Master Agreements (1993 Edition). Two others are also particularly widely used: the User's Guide to the 1994 ISDA Credit Support Annex (the Credit Support Annex governed by New York law), and the User's Guide to the ISDA Credit Support Documents under English Law.

User's Guides contain explanation of provisions contained in published ISDA documentation, as well as, sometimes, discussion of additional provisions that parties might like to consider including in their documentation.

In addition to the formal "User's Guides", ISDA is increasingly preparing commentaries to accompany new documentation. For example, there is a commentary on each of the three recently published supplements to the 1999 Credit Derivatives Definitions, on the 2001 Cross-Agreement Bridge and on the October 2001 Form of Amendment to the ISDA Master Agreement.

10. Protocol

ISDA has now published four "Protocols" (the EMU Protocol, the EMU Protocol (Greece), the 2001 Credit Support Protocol and the 2001 Euro Protocol). What are Protocols?

If you have a number of contracts with a number of different counterparties, and if you want to amend all of them in a certain way, traditionally you would be forced to negotiate with each counterparty individually (you would negotiate "bilaterally"). If you have a large number of contracts, this could be very time consuming and expensive.

Protocols are an innovative way of enabling parties to amend all of their contracts at once (or "multilaterally"). They offer market participants huge time- and cost-saving benefits.

If a party signs up to a Protocol (by delivering an "Adherence Letter" to ISDA), it is agreeing to amend all of its contracts (such as its ISDA Master Agreements) in a particular way. Of course, the agreement of the other party to each contract is required, so the Protocols provide that a contract is only amended if the other party to the contract, by itself signing up to the Protocol, also agrees to amend the contract.

Further, the Protocols include a range of different amendments in various "Annexes". A party can choose which amendments it wishes to make to its contracts by specifying, in its Adherence Letter, which Annexes it wishes to apply. If both parties to a contract sign up to a Protocol, but they have not specified the same Annexes in their Adherence Letters (i.e., there is agreement on some, but not all, of the proposed amendments), the Protocol provides that the contract in question is amended only by those amendments that both parties have agreed to make.

ISDA facilitates this amendment process by receiving Adherence Letters from market participants, checking that the letters have been completed correctly, and, on its website, displaying the letters it has received together with a list of those market participants that have signed up to the Protocol ("Adhering Parties"). The list of Adhering Parties enables Adhering Parties to ascertain with whom they have amended their contracts.

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This paper does not constitute legal advice and should not be relied upon as such.