Overcoming obstacles

International Swaps & Derivatives Association (Isda)'s first Protocol attracted over 1,100 adherents. Now that the Association has published a Protocol to assist users of its 2002 Master Agreement, John Berry* believes that record may be in danger

On 15th July, Isda published its 2002 Master Agreement Protocol (the "Protocol"). This followed the publication, in January, of the much-anticipated 2002 Master Agreement, the successor to Isda's 1992 Master Agreement (Multicurrency-Cross Border).

Over time, the 2002 Master is expected to take over from the 1992 Master as the agreement that provides the principal contractual basis for an international OTC derivatives business that, according to latest estimates, has an outstanding notional amount of $142 trillion.[1] For reasons discussed in this article, the Protocol is expected to play a significant role in that transition.

Why a protocol?

The purpose of the Protocol is to provide market participants with an efficient means to address a number of issues that would otherwise arise where certain documents published by Isda before 2002 are used in connection with a 2002 Master.

These issues may arise because pre-2002 Isda documents (including definitional booklets and credit support documents) predate the 2002 Master and so were not (and could not have been) drafted with the 2002 Master in mind. Instead, most of them were drafted with the 1992 Master in mind. They, therefore, contain a variety of provisions that assume that the parties have entered into a 1992 Master and that rely upon terms and concepts contained in the 1992 Master that do not have any particular relevance in the context of the 2002 Master. This gives rise to the potential for real ambiguity if these documents are used unamended in connection with a 2002 Master.

While parties are free to address the issues in confirmations for individual transactions and in credit support arrangements, this approach is not ideal. Even if the parties could agree on an approach, addressing the same issues each time they enter into a transaction that incorporates the terms contained in a pre-2002 definitional booklet would impose a heavy operational burden. Risks may also arise through issues being addressed inconsistently in different documents.

The purpose of the Protocol is to provide market participants with a simple, inexpensive and "once and for all" solution.

What is a protocol?

The protocol approach was pioneered in 1998, when Isda published its EMU Protocol to enable participants in the OTC derivatives markets to confirm their intentions with respect to certain issues arising as a result of the start of the third stage of European economic and monetary union.

Figure 1. Summary of common issues

- "Isda Master Agreement" defined by reference to the 1992 Master rather than the 2002 Master.
- References to "Market Quotation" and "Loss" (no contemplation of Close-out Amount).
- References to "Termination Event" – do not take into account the fact that the 2002 Master provides for a different valuation regime for Illegality and Force Majeure Event.
- Definitions of "Confirmation" and references to "applicable condition precedent" and "Termination Currency" do not reflect changes in 2002 Master.

Figure 2. Documents covered

1991 Definitions	1997 Bond Option Definitions
1998 Supplement	1997 Bullion Definitions
2000 Definitions	1997 Short Form Bullion Definitions
1992 FX Definitions	1999 Credit Definitions
1998 FX Definitions	New York Credit Support Annex
1993 Commodity Definitions	English Credit Support Annex
2000 Commodity Supplement	English Credit Support Deed
1994 Equity Option Definitions	Japanese Credit Support Annex
1996 Equity Definitions	2001 Margin Provisions

The key benefit that persuaded over 1,100 market participants to sign on or "adhere" to the EMU Protocol was its multilateral mechanism, which enabled adhering parties to reach agreement with each other adhering party through one simple act. The need to enter into costly and time consuming bilateral negotiations was largely eliminated. An additional benefit, for many, was that the multilateral mechanism contemplated "selective adherence". In other words, there was flexibility in the terms that adhering parties could select to apply. This flexibility existed because the EMU Protocol set out various standardised provisions in separate "annexes", and adhering parties could select the annexes that they wished to apply. To the extent that the selections of any two adhering parties matched, the selected provisions applied as between those two parties.

The 2002 Master Agreement Protocol also offers these benefits.

Figure 3. How the issues are addressed

References to the 1992 Master

Pre-2002 Isda documents often contain references to the 1992 Master (or its predecessors). For example, "Isda Master Agreement" is often defined by reference to the 1992 Master. The Protocol provides for these references to be deemed to be replaced with references to the 2002 Master.

Definitions of "Confirmation"

Definitions of "Confirmation" contained in pre-2002 definitional booklets refer to documents and other confirming evidence exchanged between the parties. The definition of "Confirmation" contained in the 2002 Master differs from that contained in the 1992 Master and its predecessors in that it refers to documents and other confirming evidence exchanged between the parties or otherwise effective for the purpose of confirming or evidencing transactions. The Protocol provides for the definitions of "Confirmation" contained in pre-2002 definitional booklets to be deemed to be similarly amended.

Conditions precedent

Pre-2002 Isda documents often contain references to conditions precedent. For example, under pre-2002 definitional booklets, amounts are frequently expressed to be payable "subject to any applicable condition precedent". The 2002 Master clearly distinguishes between conditions precedent for the purpose of Section 2(a)(iii) of the 2002 Master and other types of conditions or contingencies. So, for example, if parties wish to apply a condition precedent in addition to the standard conditions precedent specified in Sections 2(a)(iii)(1) and (2), they must specify such a condition as a condition precedent for the purpose of Section 2(a)(iii). The Protocol similarly seeks to clarify references to conditions precedent in pre-2002 documents.

"Termination Currency"

Pre-2002 Isda documents often refer to the currency "specified as the Termination Currency" in the Isda Master Agreement. Unlike under the 1992 Master, there is no requirement under the 2002 Master to specify a Termination Currency, since it provides a fallback if a Termination Currency is not specified. The Protocol provides for amendments to be deemed to be made to pre-2002 documents to take account of this change.

Cash settlement provisions

Some pre-2002 definitional booklets (the 1998 Supplement and the 2000 Definitions) include various methods of cash settlement where a swap terminates due to the exercise of an option to terminate or the operation of a mandatory break clause. Some of these methods rely on "Market Quotation", as defined in the 1992 Master. Since Market Quotation has been replaced in the 2002 Master with "Close-out Amount", the Protocol provides that Close-out Amount will be deemed to apply instead of Market Quotation (although it preserves the procedure of determining the cash settlement amount payable by obtaining quotations from reference banks).

Mini close-out provisions

Several pre-2002 definitional booklets provide for the close-out of a single transaction (or, sometimes, a number of transactions) in certain circumstances (for example, if a party cannot make the delivery required under a physically-settled option due to circumstances outside its control). These provisions stipulate that there will be a Close-out of the affected transaction(s) in accordance with Section 6 of the Isda Master Agreement (ie the 1992 Master) as if a Termination Event or an Additional Termination Event had occurred, either on the basis that one party is the sole Affected Party or on the basis that there are two Affected Parties. Some of these provisions provide for Market Quotation to apply; others provide for Loss to apply. The Protocol provides instead for Close-out Amount to apply. Where replacing references to Market Quotation (rather than Loss), the Protocol preserves the procedure of determining the amount payable by obtaining quotations from one or more third parties.The Protocol also clarifies those mini Close-out provisions that deem that a Termination Event (rather than an Additional Termination Event) has occurred. When used in connection with a 2002 Master, these provisions would give rise to ambiguity, since the 2002 Master provides for a different (mid-market) valuation procedure if transactions are terminated as a result of an Illegality or a Force Majeure Event rather than any other type of Termination Event. The Protocol resolves the ambiguity by making clear whether what is deemed to have occurred is either an Illegality or a Force Majeure Event or any other Termination Event. Where these provisions provide that the close-out will be carried out on the basis that there are two Affected Parties, the Protocol provides that an Illegality or a Force Majeure Event will be deemed to have occurred, thereby making use of the mid-market valuation procedure contained in the 2002 Master.

Credit Support Provisions

The Protocol includes standardised amendments to each of Isda's credit support documents to take account of the introduction of Close-out Amount in the 2002 Master. For example, the Protocol includes amendments to provisions describing how "Exposure" is to be determined. Also, in those credit support documents that include the concept of a "Specified Condition", "Force Majeure Event" is added to the list of events that can be specified as Specified Conditions.

How does the Protocol work?

The Protocol includes, in 18 different annexes, standardised amendments to each of Isda's pre-2002 definitional booklets and credit support documents in which potential issues have been identified.

To adhere to the Protocol, a party has to complete a standard form letter indicating which of the 18 annexes it wishes to apply, produce a conformed copy of the letter (by typing in the name of the signing officers) and forward both copies, together with a cheque for $500, to Isda's office in either New York or London. Where or to the extent that a party's selection of an annex matches the selection of another adhering party, the amendments contained in that annex will be deemed to be made whenever the relevant pre-2002 Isda document is used in connection with a 2002 Master between them. As you might expect, those amendments will not apply when the relevant pre-2002 document is used in connection with any other form of agreement between adhering parties, including a 1992 Master (otherwise, other difficulties would arise).

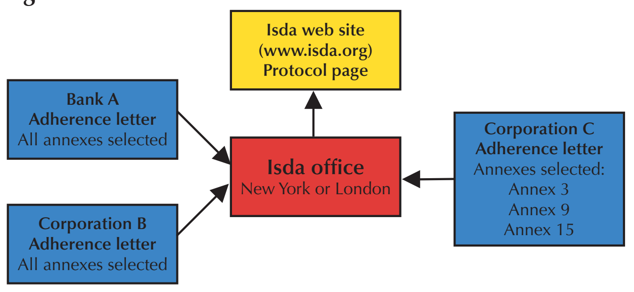
To help explain the "selective adherence" concept, figure 4 illustrates the selections that three adhering parties might make (although it is expected that most adhering parties will, in fact, choose to select all 18 annexes to take maximum advantage of the benefits offered by the Protocol). In this example, the provisions contained in each of the 18 annexes will apply as between Bank A and Corporation B, since they have each selected all annexes. However, only the provisions contained in annexes three, nine and 15 will apply as between Bank A and Corporation C and as between Corporation B and Corporation C, since, although Bank A and Corporation B have each selected all annexes, Corporation C has only selected those three annexes.

Parties wishing to adhere to the Protocol must ensure that they deliver their adherence letters to Isda before the end of the adherence period. The adherence period is scheduled to end on 1 March, 2004, although Isda reserves the right to extend the deadline for an additional period of up to three months in certain circumstances.

Forward-looking

Since the Protocol is only open for a limited period and since market participants will continue to enter into 2002 Masters following the end of the adherence period and before Isda updates its entire library of documentation, the Protocol is forward-looking. In other words, it contemplates that selected terms will apply not only with respect to 2002 Masters that have already been entered into between two adhering parties but also with respect to any 2002 Master subsequently entered into between two adhering parties (whether before or after the end of the adherence period).

Figure 4.



This ensures that the benefits of the Protocol are available not only to those market participants who have already entered into a 2002 Master, but also to any market participant that contemplates that it might in the future enter into a 2002 Master.

Isda's role

Isda acts, for certain purposes, as an agent for adhering parties. It receives adherence letters and administers the Protocol process. A significant part of this process revolves around Isda's website (www.isda.org). To enable adhering parties to keep track of others adhering to the Protocol, the website displays a list of adhering parties, which is updated from time to time. This list also offers other potential benefits since being on that list demonstrates preparation and readiness to do business on the latest terms. At the time of writing, then, congratulations to early adherents Zürcher Kantonalbank and Stichting Pensioensfonds ABP!

Also displayed on the website is the conformed copy of each adherence letter received by Isda. Other available materials include a copy of the Protocol, a form of adherence letter, details of how to adhere, a set of frequently asked questions (together with answers) and supporting legal opinions on the enforceability of the protocol procedure under English law and New York law, each provided by Allen & Overy.

Why adhere?

Every separate trading entity participating in the international OTC derivatives markets should consider adhering to the Protocol, whether or not they have yet entered into a 2002 Master. The 2002 Master is expected to become, over time, the standard agreement used in these markets, but it could be several years before all of the publications covered by the Protocol become obsolete. So, even market participants who do not yet contemplate entering into a 2002 Master should consider adhering.

The Protocol has a number of advantages, including:

❑ Multilateral mechanism saves time and cost
❑ Comprehensive coverage
❑ Forward-looking
❑ Results from widespread consultation among Isda members
❑ Supported by legal opinions.

Conclusion

The Protocol represents an excellent opportunity for all participants in the international OTC derivatives markets, whether or not they are Isda members and whether or not they have already entered into a 2002 Master. It provides a quick and easy means to overcome several potential obstacles to using the new state of the art Isda Master Agreement now and in the years to come. It would be no surprise, therefore, if the final number of adherents to the Protocol eclipses the impressive number that adhered to Isda's EMU Protocol in 1998. ❑

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[1] According to figures published by the Bank for International Settlements in June 2003.