Economic Sanctions Programs & Derivatives

Issues for Derivatives Transactions and Principles for Minimizing Impact on Non-sanctioned Entities and Avoiding Market Disruption

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1. INTRODUCTION

Since 1985, the International Swaps and Derivatives Association (ISDA) has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 950 member institutions from 71 countries. These members comprise a broad range of derivatives users, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearinghouses and repositories, as well as law firms, accounting firms and other service providers.

Derivatives are used by virtually all of the world's major financial institutions, as well as corporations, insurance companies, pension funds, asset managers and other end-users and investors to manage risks and to access financial markets. Deep, liquid derivatives markets which function smoothly and efficiently and are subject to appropriate regulatory oversight are vital to effective risk management and reduction of costs for end-users, benefitting the global economy.

Since 2014, lawmakers in the US, the EU and elsewhere have expanded the use of targeted economic sanctions to achieve foreign policy objectives and have introduced new breeds of sanctions programs affecting some entities that are highly integrated into the global economy due to their participation in international trade and networks of global subsidiaries. In some cases, lawmakers in one jurisdiction have acted unilaterally. In other cases, there has been some coordination of sanctions programs across major economies. However, significant differences in the legal and regulatory framework, scope and targeted entities across jurisdictions, as well as potential conflicts with existing legal and contractual obligations and regulatory requirements, create compliance challenges for global businesses.

The imposition of these international economic sanctions by governments, either unilaterally or on a coordinated basis across jurisdictions, may cause uncertainty and potential economic harm for non-sanctioned entities that are participants and service providers in derivatives markets, and potentially reduce the efficacy of risk-reducing regulatory mechanisms. To maximize their efficacy, economic sanctions programs may be enacted with little forewarning and are subject to a strict liability regime with heavy penalties for non-compliance. This, together with the bespoke nature of each program and the attendant uncertainty for the derivatives market, may cause short-term illiquidity, contagion and market dislocation in these markets which in turn can lead to significant financial losses for non-sanctioned entities.

To a limited degree, through the use of licenses, FAQs and other administrative guidance, clarification on some issues affecting derivatives has been provided on an ad hoc basis, either contemporaneously or in response to concerns raised by users and industry groups. Such ad hoc clarification, and the adoption of industry initiatives to promote orderly settlement of derivatives contracts, has helped to reduce the financial impact of recently-enacted sanctions programs, while maintaining the overall effectiveness of these sanctions programs in achieving their intended purpose. However, uncertainty remains and absent clear future guidance, there is a substantial risk of unintended consequences from future sanctions programs for derivatives counterparties pursuing legitimate hedging and investment strategies.

In this paper, we explore these issues by reference to examples of recently-enacted sanctions programs, notably US and EU Russia and Ukraine-related sanctions programs and US sanctions programs with respect to Venezuela.

This paper identifies areas where ISDA believes all users of derivatives would benefit from coherent guidance on the application of existing sanctions programs and in respect of any extension of those programs and future sanctions programs and sets out recommended principles for lawmakers and regulators to consider in the enactment, oversight and enforcement of these programs.

ISDA and its members are committed to full compliance with all sanctions programs promulgated by their respective regulators and ISDA has actively and constructively engaged with sanctions authorities to promote certainty and market functioning in accordance with ISDA's overall mission statement to foster safe and efficient derivatives markets to facilitate effective risk management for all users of derivatives products.

Terminology

In this paper we refer to the imposition of economics sanctions as a "**sanctions program**" and any legal or regulatory body that imposes or administers a sanctions program as a "**sanctions authority**". Any entity that becomes the target of a sanctions program is referred to as a "**sanctioned entity**" and any other entity that is required to comply with a sanctions program as a "**non-sanctioned entity**".

In this paper, we also make a distinction between derivatives transactions entered into by a non-sanctioned entity <u>with a sanctioned entity</u>, which we refer to as "**Direct Transactions**", and derivatives transactions entered into by two non-sanctioned entities <u>but which reference a sanctioned entity</u> (or obligations or instruments of that sanctioned entity), which we refer to as "**Reference Transactions**".

Direct Transactions may include any type of derivative. The most common forms of derivative transactions relate to the hedging of interest rates and foreign currency fluctuations and include *interest rate swaps, currency swaps* and *foreign exchange forwards*

Reference Transactions comprise only derivatives that are linked to underlying financial instruments. These include *credit derivatives* (such as *credit default swaps*), which are linked to debt obligations of a sanctioned entity and *equity derivatives* (such as *equity swaps, equity options and equity forwards*), which are linked to shares of the sanctioned entity or share indices which include a sanctioned entity as a component

For convenience we also include a glossary at the end of this paper, which describes the above products in more detail and includes an explanation of some other commonly-used terms in this paper (shown in *italics*).

2. EXECUTIVE SUMMARY AND GENERAL PRINCIPLES

2.1 Executive Summary

The expanded and increasingly novel use of targeted economic sanctions programs in recent years has created areas of uncertainty for users of derivatives. Economic sanctions programs historically focused on prohibiting all dealings with the highest-risk countries and entities. These sanctioned entities did not generally have significant connections to the global financial markets. However, sanctions programs introduced since 2014 have been more focused and have affected some countries and entities that are highly integrated into the global economy. These programs limited origination, trading and ancillary activities involving certain debt and equity instruments or other financing arrangements with specified entities in strategically-targeted industries or sectors. This recent focus on financial instruments has potential ramifications for the derivatives market and there has been limited and inconsistent guidance on how, if at all, sanctions programs are intended to impact derivatives.

Cash instruments, such as debt and equity securities, are typically settled between a buyer and a seller in full within a few days after a trade is concluded. By contrast, derivatives are bilateral financial contracts which are usually subject to ongoing payment, delivery and *margining* obligations on each party throughout the life of the transaction (which could be 30 years or longer) based on the price or level of referenced underlying assets, rates or indices, or other predetermined contingencies. As such, the value of derivatives transactions is subject to constant fluctuation, creating exposures (including credit exposures) between counterparties, which are generally managed through the application of *close-out netting* and through the use of daily *margining* arrangements that are often required by regulations.

Derivatives are primarily governed by *ISDA Master Agreements*, which enable parties to value their positions, manage their exposure and promptly terminate their transactions and crystallize and realize their value upon the occurrence of certain events that jeopardize continued performance of one or both parties' obligations.[1] These are core principles on which derivatives markets operate and are vital to global financial functioning. Restrictions on parties' ability to terminate, transfer or unwind derivatives where performance is prohibited or otherwise jeopardized by sanctions may create unquantifiable, open-ended and *unhedged liabilities*, costing *regulatory capital*, limiting future trading activities and increasing costs for end-users.

Derivatives also allow parties to gain exposure to underlying entities, obligations, instruments or other financial assets without any requirement to have any relationship with those entities or to hold those financial assets. Where those entities become sanctioned entities, trading in those derivatives may be impacted notwithstanding that such trading does not confer any direct benefit on, or directly involve dealings with, the sanctioned entity. If that sanctioned entity is included in a credit or equity index, that impact could extend to contracts with trillions of dollars in outstanding *notional amounts* and cause substantial financial losses for parties attempting to unwind or otherwise hedge their positions.

A significant portion of derivatives are transacted on a cross-border basis. Numerous different legal and regulatory regimes may be relevant for each transaction, including the laws of the jurisdiction of each counterparty (and its parent and/or guarantor), the governing law of the contract, the law of the jurisdiction where any collateral is held and the laws applicable to any

[1] This does not include exchange-traded products that are subject to the rules of an exchange.

underlying reference entity or asset. In addition, the largest global financial institutions are, in many cases, required to adopt global standards – if sanctions are adopted by one country in which they operate, they may be required to comply with those sanctions globally or face exclusion from doing business in that country or other consequences. The cross-border nature of the derivatives market and the long-arm jurisdiction of national regulators over its largest actors create compliance challenges where actions required by sanctions programs unilaterally imposed by one country conflict with the laws and regulations of other countries that are directly applicable to those derivatives.

These (and other) unique characteristics of derivatives raise difficulties in interpreting how sanctions programs should apply in the context of derivatives. These issues broadly arise from the potential and uncertain effects of economic sanctions programs on:

- the ability of non-sanctioned entities to avail themselves of the rights and protections enshrined in market-standard trading agreements such as the ability to promptly terminate transactions and crystallize their value when a counterparty fails to perform its obligations or such performance becomes illegal or impossible

- the treatment of credit exposure inherent in bilateral derivatives trading relationships and the use and effectiveness of *margining* arrangements to mitigate that exposure

- transactions that a sanctioned entity enters into as part of its treasury management operations such as interest rate or foreign currency hedging when such operations may also include the issuance by that sanctioned entity of obligations or instruments that are subject to restrictions under those sanctions programs

- transactions entered into between non-sanctioned parties which include terms which reference underlying entities, obligations or instruments that become subject to restrictions under those sanctions programs

ISDA believes these uncertainties can be minimized for current and future sanctions programs in a manner that is consistent with sanctions authorities' foreign policy and national security goals without conferring any benefit on the sanctioned entity or otherwise diminishing the efficacy of the sanctions programs. This can be achieved through sanctions authorities providing appropriate guidance which reflects the general principles set out in this paper.

2.2 General Principles

When introducing new sanctions programs or extending existing sanctions programs, ISDA would urge sanctions authorities to be cognizant of the issues raised in this paper.

In particular, ISDA recommends that interpretive guidance be provided contemporaneously with any sanctions program which expressly addresses the intended effects of that program on derivatives transactions. In formulating such guidance, ISDA proposes that the following eight principles would ensure the continued safe operation of derivatives markets and minimize market disruption and economic consequences for non-sanctioned entities, without compromising foreign policy or national security goals, conferring any benefit on sanctioned entities or otherwise harming the objectives of any sanctions program:

1. Sanctions programs should provide clarity and certainty as to which, if any, derivatives transactions are intended to be affected by those programs and the actions that non-sanctioned entities are required to take in respect of those transactions.

2. Where performance of derivatives transactions would be affected by sanctions programs, non-sanctioned parties should be given a reasonable period of time of not less than 30 days to *close out*, *voluntarily unwind* or *novate* transactions in accordance with their terms, provided that, if required under the relevant sanctions law, any payments to sanctioned parties are made into blocked accounts.

3. Non-sanctioned parties should be permitted to net or set-off any collateral or margin received or posted under credit support documentation against amounts owed by or to sanctioned parties, provided that, if required under the relevant sanctions law, any excess collateral owed to sanctioned parties is held in blocked accounts.

4. In line with guidance previously provided, counterparty credit exposure under derivatives transactions or collateralization arrangements arising in the ordinary course of a derivatives trading relationship should not constitute an 'extension of credit' for the purposes of any prohibitions on dealings in new debt of a sanctioned entity.

5. Derivatives transactions entered into in the ordinary course of the derivatives trading relationship should not be considered as 'facilitation' or 'services in support' of prohibited new debt, equity or other instruments unless the rights and obligations under those transactions are expressly linked to the issuance, performance or existence of such prohibited instruments.

6. In line with guidance previously provided, non-sanctioned entities should be permitted to enter into derivatives which reference underlying entities (or their obligations or instruments) that have become sanctioned entities and to perform their obligations under those transactions. Such performance should include the limited right of non-sanctioned entities to transfer prohibited debt, equity or other instruments of the sanctioned entity to the extent necessary to enable the orderly settlement of those transactions in accordance with established industry processes.

7. As far as practical and within the legal framework of each relevant jurisdiction, sanctions authorities should ensure that where sanctions programs are imposed in a coordinated basis the approach to derivatives is harmonized to avoid uncertainty.

8. Where obligations under specific sanctions programs might create conflict with other sanctions programs or with other legal, regulatory or contractual obligations on non-sanctioned entities, as far as practicable sanctions authorities should ensure that such conflict does not arise or provide clear guidance as to how non-sanctioned entities are to resolve such conflict.

3. THE DERIVATIVES MARKET

3.1 Derivatives are widely used by virtually all major financial institutions and other entities and provide a vital tool to manage financial risks and access financial markets

The derivatives market is essentially a mechanism by which financial institutions and other parties transfer risks among themselves through contracts in which parties agree to pay (or make deliveries of assets to) each other in the event of rate movements, price changes, and other contingencies, such as a defined non-performance by a third party. Derivatives are used by virtually all of the world's major financial institutions, as well as corporations, insurance companies, pension funds, asset managers and other end-users and investors to manage risks and to access financial markets. Derivatives allow parties to gain exposure to underlying entities, obligations, instruments, commodities, currencies or other financial assets without any requirement to have any relationship with those entities or to hold those financial assets.

3.2 The derivatives market is very large in size and highly interconnected such that any impairment to its operation can have significant economic consequences

The latest data from the Bank of International Settlements[2] indicates that at the end of the first half of 2019, derivatives *notional amount* outstanding totaled $640.4 trillion, while gross market value was $12.1 trillion. Interest rate contracts comprised approximately 82% of *notional amount* outstanding, while foreign exchange contracts accounted for about 15%. Credit derivatives, equity derivatives and commodity derivatives made up about 1.3%, 1.1% and 0.3%, respectively, of *notional amount* outstanding at the end of the first half of 2019.

Multiple derivatives are executed in respect of the same underlying assets or obligations to manage and trade the risks on an ongoing basis. This creates many interconnected trades between entities which themselves often carry very little actual market or credit risk provided those contracts operate as intended. However, if there is disruption to the operation of those contracts, these figures highlight the potential significant economic effects on individual participants and overall market functioning.

3.3 Derivatives have fundamental differences to cash instruments

Unlike cash instruments such as debt and equity securities, derivatives are bilateral obligations which are subject to ongoing payment, delivery and *margining* obligations on each party throughout the life of the transaction based on the price of referenced underlying assets, rates or indices, or other predetermined contingencies. As such, the value of derivatives transactions is subject to constant fluctuation.

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[2] https://www.bis.org/statistics/derstats.htm (Statistics reflect amounts of over-the-counter derivatives outstanding).

Also unlike most cash instruments, derivatives are not freely transferable without both parties' consent.[3]

3.4 Derivatives are principally used by end users to manage risks for businesses and consumers

Most derivatives transactions are traded with (or among) global systemically important financial institutions through trading hubs in the major global financial centers. An ISDA research study in 2014[4] based on publicly available data published by the Bank for International Settlements concluded that 65% of interest rate derivatives market turnover involves an *end user* (including pension funds, insurance companies, banks and building societies and asset managers) on one side and a *dealer* on the other. The remaining 35% of derivatives turnover activity relates to *dealer* market-making and the hedging of customer transactions – vital for market liquidity and the facilitation of client trades.

3.5 The safe and efficient functioning of the derivatives market relies on robust and legally enforceable market-standard documentation

The vast majority of non-cleared derivatives are governed by one of the standard form *ISDA Master Agreement* documents published by ISDA. Most derivatives are also subject to *margining* arrangements under an *ISDA Credit Support Annex* to the *ISDA Master Agreement*, which provide for parties to exchange bilateral margin on a daily basis to cover the net *mark-to-market* credit exposure across their entire trading relationship. Legal certainty as to the enforceability of derivatives contracts in accordance with their terms is vital to ensuring that markets are safe.

In particular, the ability to terminate (or '*close out*') transactions upon a counterparty default, determine a single net settlement amount in respect of all terminated transactions and apply posted collateral to satisfy that obligation, is the cornerstone of the entire derivatives market. ISDA commissions regularly-updated opinions from leading law firms in more than 60 jurisdictions across the globe confirming the legal effectiveness of the *ISDA Master Agreements* and associated collateralization arrangements against most common entity types in these jurisdictions, including in the event of bankruptcy proceedings. The conclusions of these opinions are used by regulated entities across the globe to comply with regulations on *regulatory capital* requirements and risk management.

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3 Certain of these features are not limited to derivatives and other financial products such as exchange traded derivatives, repos, securities lending arrangements and margin loans have common features with certain derivatives. As a result, sanctions programs that impact derivatives markets may raise similar issues in the markets for these products. Separate consideration of the effect of sanctions programs on the markets for these other products is outside of the scope of this paper but adopting guidance applying similar general principles as those outlined in this paper may also provide clarity and stability to these markets.

4 "Dispelling Myths: End-User Activity in OTC Derivatives (August 2014), available as https://www.isda.org/a/WPDDE/isda-dispelling-myths-final.pdf

3.6 Derivatives may be either cleared through central counterparties (CCPs) or settled directly between counterparties (non-cleared)

A significant proportion of the derivatives market (including more than two thirds of the notional amount of the global interest rate swap market) is cleared through central counterparties. CCPs are a key component of managing systemic risk in the financial system, taking on the credit risk associated with a derivatives transaction between counterparties by acting as the counterparty to each side of the transaction. The CCP's counterparties are limited to the members of the CCP, and the transactions between a CCP and its members are governed by that CCP's rulebook. A non-member can also clear derivatives on a CCP by entering into a client clearing relationship with a clearing member. The derivatives transaction relationship between a clearing member and its client are primarily governed by agreements that rely on a legal framework similar to that for non-cleared derivatives. The CCP mitigates its own exposure by, among other things, collecting margin from each of its clearing members, as well as contributions to a default fund, and by maintaining its own capital. Similarly, clearing members acting for clients will manage the default risk of those clients and collect margin from those clients for their cleared transactions.

If derivatives transactions are settled directly between two counterparties rather than through a CCP, they are said to be non-cleared. Experience with recently-enacted sanctions programs suggest that issues have primarily impacted non-cleared derivatives, so they are the primary focus of this paper. The CCP-clearing member relationship is governed by CCP rulebooks that allow CCPs to readily manage member transactions, while the clearing member-client relationship relies on a legal framework similar to that for non-cleared derivatives. Therefore we expect that the issues and principles discussed in this paper with respect to non-cleared derivatives could also be applicable in the context of cleared derivatives, although the effects of sanctions programs may have a more limited impact. In the CCP- clearing member context, if an entity that becomes subject to sanctions is a CCP member, the CCP may be able to manage that specific member relationship without impacting other clearing members and their clients. Similarly, if a sanctioned entity is a client of one or more CCP clearing members, only those clearing members would be directly impacted by the sanctions.“

3.7 The global derivatives market is highly regulated in all major economies

In response to the global financial crisis of 2008-2009, the G20 agreed to a financial regulatory reform agenda covering the derivatives market and users of derivatives. In particular, regulations have been introduced across all major economies requiring: derivatives to be reported to trade repositories; mandatory trading on a trading venue and *clearing* of certain standardized derivatives; mandatory daily variation (and, for the largest users, initial) *margining* for non-cleared derivatives; and other risk management, documentation and business conduct requirements.

3.8 Derivatives are often traded on a cross border basis and involve at least two different legal and regulatory regimes

As *dealers* trade with *end users* (and each other) through global and regional hubs to maximize liquidity and *regulatory capital* efficiency, a large proportion of the derivatives market is cross-border. The global nature of the derivatives market offers significant advantages to users. These advantages include pricing transparency, liquidity, orderly trading and a diversified range of potential counterparties which reduces systemic risk. At the individual *end user* level, risk mitigation techniques such as hedging and portfolio diversification are most easily achieved at the lowest cost in such an environment.

Numerous different legal and regulatory regimes may be relevant for each transaction, including the laws of jurisdiction of each counterparty (and its parent and/or guarantor), the governing law of the contract, the law of the jurisdiction where any collateral is held and the laws applicable to any underlying reference entity or asset. Following the regulatory reforms described above, virtually all derivatives globally are subject to substantial regulatory oversight with cross-border transactions often subject to regulation in multiple jurisdictions.

4. ISDA MASTER AGREEMENTS

4.1 Introduction

Virtually all non-cleared derivatives are governed by one of the standard form *ISDA Master Agreement* documents published by ISDA. An *ISDA Master Agreement* creates a single contractual agreement governing the trading relationship between two parties, typically a *dealer* and an *end user* or two *dealers*. Although there are several versions of the *ISDA Master Agreement* and parties may tailor the agreement to their own needs, the core provisions and concepts discussed in this paper are generally present in all such agreements.

4.2 Termination and Close-out Netting Provisions

The terms of the *ISDA Master Agreement* provide that some or all transactions may be terminated (or *closed out*) in certain circumstances; for example, if it becomes unlawful for a party to perform its obligations, a party is prevented from performing its obligations by reason of a force majeure or act of state, or a party is subject to bankruptcy, fails to properly discharge its obligations or suffers a credit impairment.

Upon any such *close out*:

- the current market value of the terminated transactions is assessed by reference to the cost to the unaffected party of replacing those transactions in the market
- a single net payment is calculated which reflects the net market value of all terminated transactions to the receiving party (the *close out* amount)
- any posted collateral may be applied to satisfy that payment and the remainder becomes due from one of the parties to the other

The ability to close out transactions and determine the net settlement amount if the relevant event or circumstance arises is a vital tool for the reduction of credit risk and the availability of credit in the financial markets:

- Without *close-out netting* firms would need to manage their credit risk on a gross basis. This would result in less credit capacity and reduced liquidity.
- The ability to manage credit risk on a net basis means more credit is available to firms looking to raise finance or hedge their exposures.
- Data from Bank of International Settlements semiannual survey shows that *close-out netting* reduced the overall gross market exposure in the derivatives market from $12.1 trillion to $2.7 trillion as of the end of the first half of 2019.[5]
- Regulators require *close-out netting* to be legally robust to a high degree of certainty and deny *regulatory capital* relief to a supervised financial firm in relation to any master agreement that is not supported by a legal basis showing that *close-out*

[5] https://www.bis.org/statistics/derstats.htm

netting works without material qualification (including in any bankruptcy proceedings).

It is also important to permit a *close out* to occur rapidly following the occurrence of the relevant event or circumstance, because the value of derivatives transactions can change quite rapidly. If there is material uncertainty as to when the affected derivative transactions can be closed out, there is a risk of creating significant credit and market exposures which can lead to contagion and consequent market dysfunction.

4.3 Termination, transfer or voluntary unwind of transactions

In addition to the *close-out* provisions discussed above, a party may also divest itself of transactions by:

- transferring (or *novating*) those transactions to another party, which generally requires the consent of the counterparty[6]
- exercising early termination options that may be included in the terms of those transactions
- voluntarily agreeing with its counterparty to terminate those transactions (including by virtue of entering into offsetting countertrades[7])

Each of the above scenarios would typically involve a payment representing the *mark-to-market* value of the relevant transactions being calculated on substantially the same basis as the determination made under the *close-out* provisions discussed above and, as with the *close-out* provisions, would enable the party to crystallize that value and avoid any open-ended and unquantifiable liabilities, while not conferring any economic benefit on the counterparty.

4.4 Additional risk-reducing provisions

ISDA Master Agreements typically also contain the following additional provisions, which further reduce the risk from a party being unable to continue to perform its obligations:

- **Payment conditionality provisions**, which provide that a party's obligation to make payments or deliveries under transactions is suspended if the other party is in default or potential default

6 Under one version of the *ISDA Master Agreement*, a party whose performance has become unlawful is required to use all reasonable efforts to transfer its obligations to another office or affiliate to eradicate the illegality as a pre-condition to its right to *close out* the outstanding transactions.

7 In some cases, particularly where derivatives are cleared through a *clearing* system, *voluntary unwinding* of a transaction is effected by means of the parties entering into an equal and opposite countertrade which cancels the economic effect of the original transaction. This is done for operational reasons only and is economically identical to the termination of the original trade. Thus, any sanctions program permitting the unwinding of transactions should be drafted so as to also permit this to be achieved through the entry of such a countertrade to avoid any difference in treatment based solely on operational factors.

- **Payment netting provisions**, which provide that where parties owe payment obligations to each other on the same day in the same currency, these are reduced to a single net payment obligation on the party obliged to pay the greater amount

- **Contractual set-off provisions**, which permit the *close out* amount calculated under the *ISDA Master Agreement* to be set off against any other amounts (whether or not arising under the *ISDA Master Agreement*) owed between the parties

- **Notification provisions**, which require a party whose performance has become unlawful to provide the other party with information about the circumstances. In some cases a party must try to reach agreement to avoid any unlawfulness that is preventing performance as a pre-condition to its right to *close out*

Together with the termination and *close-out* provisions discussed above, the effect of these provisions is to limit the overall credit exposure that the parties have to each other, thereby minimizing potential economic losses from changes in circumstances. It is therefore important that during any wind-down period permitted under a sanctions program non-sanctioned entities continue to be able to avail themselves of these risk-reduction provisions. For example, if a sanctions program were to prevent a non-sanctioned entity from engaging in discussions with a sanctioned entity and as a consequence the non-sanctioned entity was not able to satisfy a pre-condition to exercising its right to *close out* then this could prevent that non-sanctioned entity from terminating its position within the wind-down period. Similarly, restrictions on a non-sanctioned entity's ability to exercise contractual set off rights between amounts owed under *ISDA Master Agreement* and amounts owing under other agreements could increase potential losses for that non-sanctioned entity.

4.5 Proposed Approach

It is important that any sanctions programs provide clarity and certainty as to which, if any, derivatives transactions and derivatives counterparties are affected by those programs. In particular, sanctions programs should clearly set out:

- whether they prevent the entry into new derivatives transactions by a non-sanctioned entity with a sanctioned entity

- whether they affect non-sanctioned entities' rights and obligations under transactions entered into prior to the enactment of the sanctions program

- any grandfathering periods and the impact of any *lifecycle events*

- that the ability to enter into, and perform obligations under, Reference Transactions should not be impeded

- that sanctions programs targeting particular financial instruments should only affect those derivatives contracts (if any) that are clearly expressed to be within the scope of those programs (and sanctions authorities should give clear and timely guidance which these are)

Where continued performance of transactions with a sanctioned counterparty is impacted because those transactions are of a type specifically within the scope of limited sanctions programs targeting that counterparty, then sanctions authorities should ensure that the interests of the non-sanctioned party and the derivatives market generally are protected. This should be achieved by allowing non-sanctioned parties:

- a reasonable wind-down period during which non-sanctioned parties may avail themselves of the protections enshrined in the *ISDA Master Agreements* to manage credit and market risks. The wind-down period should not be less than 30 days and sanctions authorities should be prepared to grant a longer period (or to extend the period) if, in taking account of all relevant factors including the size, volume and liquidity of the sanctioned entity's positions, this is required to ensure that there is an orderly unwind to avoid any unnecessary market disruption for non-sanctioned entities

- to exercise their rights to terminate transactions pursuant to the illegality or event of default provisions of the *ISDA Master Agreement* or any other provisions that the parties have included to provide for early termination of the transactions

- to fulfil any contractual conditions to any such termination (such as the delivery of notices, the sharing of basic information about the reasons for the termination and any obligation to attempt to transfer the transactions, if applicable) and the non-sanctioned party should be able to determine the relevant net settlement amount under the *close-out* provisions

- to *novate* or *voluntarily unwind* (including by way of countertrade) the affected transactions within the relevant wind-down period

- to continue to exercise any contractual rights of payment netting and payment conditionality prior to termination and any rights of set-off in relation to any net settlement amount following termination.

We believe that these actions would confer no material economic benefit on the sanctioned counterparty. In particular, any *close out* under the *ISDA Master Agreement* is not intended to bestow an economic benefit on either of the parties, nor is it intended to deprive either of the parties of any economic benefit associated with the terminated transactions. The valuation process in economic terms simply represents the net balance (i.e. the net current cash value) of the rights and obligations (both present and future) of each party. The calculation of the net settlement amount generally seeks to put the parties in the same economic position that they would have been had the *close out* not occurred such that each of the parties has received the current fair value in lieu of the continued existence of the transactions. If the relevant sanctions program requires assets to be frozen in blocked accounts then this can be achieved by the non-sanctioned party paying (or receiving) any settlement payment into a blocked account and holding those funds in accordance with the sanctions. By doing so, the party will have effectively 'frozen' the asset of the sanctioned counterparty constituted by the derivatives transactions.

Maintaining legal certainty for the non-sanctioned counterparty to exercise its contractual rights will allow for an orderly unwind of these transactions (and any associated hedge positions) and avoid the non-sanctioned party having to maintain a fluctuating, unquantifiable liability on its balance sheet for an indeterminate amount of time until sanctions are lifted. Although unwinding transactions may cause some temporary disruption, particularly if the sanctioned entity was a significant user of derivatives, any risk of contagion could be contained. However, restricting a party's ability to orderly terminate or *novate* the transactions and crystallize their value in circumstances where the parties are prohibited from performing their obligations under those transactions creates unquantifiable, open-ended and *unhedged liabilities*. These liabilities cost *regulatory capital*, which limits trading activities, reduces liquidity and consequently increases costs for end-users.

5. COLLATERAL ARRANGEMENTS

5.1 Overview of collateral arrangements

Most *ISDA Master Agreements* are supplemented by collateral annexes, principally the English law and New York law forms of *ISDA Credit Support Annex*. Pursuant to the G20 derivatives regulatory reforms, since 2016 most significant users of derivatives have been required to post and collect margin in the form of cash and high quality liquid securities on a daily basis to cover the net *mark-to-market* exposure on their derivatives portfolio. Even where counterparties are not subject to these mandatory requirements, voluntary collateral arrangements are often put in place to mitigate credit and market exposure.

The value of the margin required to be posted is calculated using substantially the same methodology as the settlement amount calculation on an early *close out* of the transactions under the *ISDA Master Agreement* (this is commonly referred to as "variation margin"). This ensures that if the transactions are terminated early, the margin posted is sufficient to cover substantially all of the settlement payment due, subject to any market volatility between the time when the requirement was last calculated and the day on which the settlement amount is calculated. This volatility risk is also often addressed by requiring counterparties to post an additional amount of margin (commonly referred to as "initial margin"), which may be held segregated with a custodian unaffiliated with either counterparty. This segregated initial margin requirement is required by regulations for the largest derivatives counterparties and is being phased in until 2021, when it will broadly affect all counterparties with more than $8 billion in *notional amount* of non-cleared derivatives.

5.2 Ongoing collateral requirements

Under *ISDA Credit Support Annexes*:

- counterparties either transfer or pledge by way of security collateral comprising cash and high quality liquid securities to each other with a value equal to the amount of any exposure that the other party has under all outstanding transactions

- an exposure calculation is made daily and is based on the amount that would be payable as a settlement amount between the parties under the *close-out* provisions of the *ISDA Master Agreement* if all of the transactions were terminated as of that day.

- the exposure calculation is compared to the value of the collateral previously posted and one party is required to top-up (or return) collateral to the other to rebalance the value of the collateral with the exposure calculation.

Owing to the potentially volatile nature of the value of derivatives, it is important that there is no delay in the calculation and posting of the required margin because this can lead to uncovered credit exposures. Any failure to post when required typically results in an event of default occurring under the *ISDA Master Agreement*, entitling the non-defaulting party to terminate all of the transactions promptly, minimizing the potential for any uncovered exposure to increase over time.

5.3 Application of collateral on close-out

Upon a *close out* of the transactions under the *ISDA Master Agreement*, the value of posted collateral may be applied towards the net settlement amount calculated under the *ISDA Master Agreement*. This is achieved either by means of netting the value of the collateral against that settlement amount or by enforcing the security interest over the posted collateral and setting off the proceeds of that enforcement against the settlement amount.

5.4 Proposed approach

As with the operation of the provisions of the *ISDA Master Agreement*, it is vital to the protection of non-sanctioned counterparties and the safe functioning of the derivatives markets that any sanctions program does not interfere with non-sanctioned parties' rights and obligations under *ISDA Credit Support Annexes*. This is because restrictions on a party's ability to demand and receive margin or to apply margin in the event of a *close out* would lead to uncollateralized credit exposure, increasing *regulatory capital* requirements and risking contagion. Uncollateralized credit exposure was a major factor in many of the failures during the global financial crisis prompting the G20 mandatory *margining* reforms.

A non-sanctioned party with transactions with a counterparty that becomes a sanctioned entity should be permitted:

- to continue to post and receive variation margin (and, if applicable, initial margin), or in the case of asset freeze/blocking sanctions, to *close out* all its transactions within a prescribed unwind period of not less than 30 days in circumstances where it is either prohibited from receiving margin or its counterparty defaults in its obligation to post margin

- upon any *close out* of transactions with a sanctioned party, to liquidate and apply the value of any collateral posted by (and offset the value of any collateral posted to) the sanctioned party against the net settlement amount determined under the *ISDA Master Agreement*, irrespective of whether the collateral has been posted by means of title transfer (and is therefore subject to netting under the *ISDA Master Agreement*) or by means of a security interest (and is therefore subject to enforcement and application towards the settlement amount)

If the relevant sanctions program requires assets to be frozen in blocked accounts then this can be achieved by the non-sanctioned party paying any excess collateral posted to it by the sanctioned entity into a blocked account and holding those funds in accordance with the sanctions.

As with the *close-out* arrangements under the *ISDA Master Agreement*, the ability of a non-sanctioned entity to continue to post and receive collateral or to apply such collateral upon a *close out* of the transactions confers no benefit on the sanctioned entity, it simply mitigates the credit exposure associated with either ongoing obligations under permitted transactions or any settlement amount determined in respect of prohibited transactions.

As described above, derivatives trading relationships give rise to ongoing and fluctuating exposures, which are successfully mitigated through robust credit support arrangements. The size and volatility of these exposures (and the accompanying requirement to post margin to cover them) are unpredictable and incidental to the trading relationship and, as such, should not be viewed as extension of credit by either party. Sanctions authorities have recognized this in at least one instance in the past, i.e. in the context of the Russia and Ukraine-related sanctions program, OFAC published an FAQ stating "OFAC does not consider normal counterparty credit exposure encountered by a US person to be an extension of credit when the US person enters into an otherwise permissible derivatives transaction". Sanctions programs should continue to make clear that neither the credit or market risk associated with derivatives transactions, nor the *margining* arrangements that are put in place to mitigate that risk (that are in many cases mandated by regulations), constitute prohibited extensions of credit to a sanctioned entity for the purposes of the relevant sanctions program.

6. DERIVATIVES AS SERVICES IN SUPPORT OF PROHIBITED INSTRUMENTS

6.1 Background

Recent sanctions programs prohibiting dealings in certain debt or equity instruments have also included prohibitions on the provision of services in support, assistance in issuance or other similarly described facilitation activities in respect of those instruments.

Although there are many obvious cases of this kind of ancillary activity (e.g., acting as an arranger, underwriter or agent on a new debt or equity issuance), determining the perimeter of such activity is challenging and there has been limited guidance from sanctions authorities on how broadly these provisions should be interpreted.

6.2 Application to derivatives

Derivatives, particularly interest rate and FX derivatives, are regularly used by major financial institutions and other large corporations to manage their treasury activities, including hedging their borrowing costs and converting money from the currency of their operations to the currency in which their liabilities are denominated. These risks are generally managed on a macro basis using standardized vanilla derivatives such as *interest rate swaps* or FX forwards. The derivatives do not reference any particular asset or liability of the entity; they merely provide for periodic payments to be made between the parties by applying a defined interest or FX rate to a fixed *notional amount*.

In some cases, where an entity issues a bond or enters into a loan agreement, it may be required (or otherwise want) to hedge its liabilities under that bond or loan by entering into specific hedging transactions. In such cases, those hedging transactions may specifically reference that obligation as, for example, they may benefit from the same security and/or covenant package as the relevant lenders or bondholders. Clearly in those cases there is a close nexus between the specific new debt that is being incurred and the derivatives that are being entered into in respect of that debt to the extent that such activity may be considered to be 'supporting' or 'assisting' in that new debt. However, outside of these specific situations, a derivatives counterparty will generally have no visibility as to its counterparty's specific purpose for entering into the transaction beyond that it intended to hedge its liabilities.

6.3 Proposal

Derivatives transactions entered into in the ordinary course of the derivatives trading relationship should not be considered as 'facilitation' or 'services in support' of prohibited new debt or other prohibited instruments unless the transactions are expressly linked to the issuance, performance or existence of such prohibited instruments.

Recent targeted sanctions programs have been quite precise about the scope of the instruments that are subject to prohibitions on dealings, limited this to new debt of specified minimum maturity and new equity, and have so far not expressly included derivatives such as foreign exchange and interest rate transactions.

If future sanctions programs continue to target specific categories of debt and equity instruments only, it is important that non-sanctioned entities have certainty that their normal trading activities will not be inadvertently fall within the scope of those prohibitions by virtue of activities of the sanctioned entities of which they are unaware.

7. REFERENCE TRANSACTIONS

7.1 Sanctions programs and Reference Transactions

Recent sanctions programs targeting certain debt and equity instruments of sanctioned entities have created uncertainty as to the status of Reference Transactions relating to those sanctioned entities and instruments, in particular whether trading in, or performing obligations under, such Reference Transactions might constitute prohibited activity with respect to the debt and equity instruments that are referenced.

7.2 Reference Transactions may either reference certain specified obligations or all obligations of specified entities that meet certain specified criteria

Some Reference Transactions (e.g., most equity derivatives) reference specified obligations or instruments (e.g., the ordinary shares of a particular entity). Other Reference Transactions (e.g., most credit derivatives) are written on a specified reference entity but the trigger events for settlement and the determination of any settlement payment are made by reference to any obligations of that reference entity that meet certain predefined criteria.

The distinction is important in the context of sanctions programs because of the potential for those programs to prohibit trading in some, but not all, obligations. For example, the sectoral sanctions on Russia imposed prohibitions on trading of debt obligations issued after the enactment of the sanctions. US sanctions on Venezuela imposed prohibitions on trading of bonds issued both before and after the enactment of the sanctions but carved out certain specified bonds existing at the time the sanctions were imposed.

While these types of sanctions provide clear delineation as to which obligations (and, by extension, which Reference Transactions written on those specific obligations) may be traded and which may not, they create uncertainty for Reference Transactions that are written only on a specified reference entity (and not on specific obligations issued by that reference entity). If one single obligation that would meet the criteria for inclusion in a Reference Transaction becomes subject to prohibitions under the sanctions program, would that obligation taint the entire contract notwithstanding that the contract does not specifically reference that obligation? Furthermore, what is the status of such a contract during the period where the sanctioned entity could issue new obligations that would meet the criteria and be subject to the sanctions by virtue of being new debt, but has not yet done so.

Similar issues arise in the context of prohibitions on dealing in new equity of a sanctioned entity. How is a reference derivative which includes shares of that entity to be treated before and after any such new issuance of equity if the new shares and old shares are indistinguishable?

7.3 Sanctioned entities or obligations may comprise only a small element of the underlying derivatives transaction

Credit, equity and other types of derivatives are often written on baskets or indices of entities or assets. Such transactions allow users to obtain exposure to a diverse pool of financial assets in a particular jurisdiction, region or sector in a single transaction. This reduces the transaction, financing and other costs associated with investing in and rebalancing an equivalent portfolio of cash assets.

Equity swaps and other equity derivatives referencing the major global equity indices such as the S&P500 and the FTSE100 account for a large proportion of the $7.0 trillion equity derivatives notional outstanding.[8] Index *credit default swap* notional outstanding was $4.2 trillion at the end of the first half of 2019.[9] The major equity indices include anywhere from tens of companies to several thousand and are generally weighted by market capitalization. The CDX and iTraxx *credit default swap* indices have between less than ten and 125 equally-weighted constituents.

If any constituent of any of these indices becomes a sanctioned entity and the sanctions program affects dealings in that entity's debt or equity obligations, any existing or prospective transaction on the relevant index may be affected unless there is clear guidance that such transactions fall outside of the scope of those sanctions.

Given the size of the market in these index transactions, any impairment to these transactions could severely impact the liquidity of the relevant market and limit non-sanctioned entities' ability to realize their value causing significant economic losses as well as a risk of contagion and market dysfunction.

7.4 Reference transactions may require the ability to physically deliver obligations in order to effect settlement

Typically Reference Transactions are cash settled without any physical delivery of underling bonds or shares. However, some single name or basket equity derivatives may provide for physical settlement by delivery of the relevant shares.

In the case of *credit default swaps*, cash settlement payments in respect of defaulted reference entities are generally determined by means of an auction process that requires the ability for users to submit buy and sell orders for physical delivery of debt obligations of the reference entity. If an auction is not held, then settlement is by physical delivery of debt obligations of the reference entity in return for receiving the full outstanding principal amount of those obligations.

As discussed further below in the context of specific issues in respect of credit derivatives, any inability of non-sanctioned entities to settle their transactions in a timely manner can lead to unquantifiable, open-ended and *unhedged liabilities*. Furthermore, circumstances where sanctions are imposed unilaterally, such that some users fall within the jurisdiction of the sanctions and some do not, risks splintering the market and imposing greater losses on non-sanctioned entities in the imposing jurisdiction.

7.5 Regulatory approach to Reference Transactions

In the context of the Russia and Ukraine-related sanctions programs, sanctions authorities recognized that Reference Transactions were outside of the scope of those

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8 https://www.bis.org/statistics/derstats.htm

9 *Id.*

programs. In the US, OFAC issued General License 1B[10] authorizing transactions by US persons involving derivative products whose value is linked to an underlying asset that constitutes prohibited debt or prohibited equity issued by a sanctioned entity, while expressly prohibiting US persons from holding, purchasing, or selling of such underlying assets. An accompanying FAQ[11] states that General License 1B "continues to authorize certain transactions involving derivative products that would otherwise be prohibited".

EU regulations on the Russia and Ukraine-related sanctions program also authorized certain transactions involving derivative products such as *interest rate swaps*, cross *currency swaps*, *credit default swaps* (except where these give the right to acquire or sell a prohibited transferable security), and derivatives used for hedging purposes in the energy market. However, derivatives which give the right to acquire or sell a transferable security or money market instrument covered by the debt/equity prohibitions, such as options, futures, forwards or warrants, remain prohibited, whether traded on-exchange or over-the-counter.

While such regulatory clarification was welcomed by ISDA and its members, uncertainty remains. The OFAC FAQ suggestion that Reference Transactions would "otherwise be prohibited" but for General License 1B, together with the absence of an equivalent general license in the context of the more recent Venezuela sanctions, leaves the status of Reference Transactions in the context of debt/equity sanctions programs as unclear. In response to another of its FAQ[12] about trading derivatives relating to Venezuela bonds on OFAC's permitted list, OFAC states "one corollary to this authorization is that US persons are not authorized to buy, sell, or otherwise deal in derivatives that reference bonds [that are not on that list]". A further FAQ[13] clarifies that General License 3D authorizes "security derivatives… ordinarily incident and necessary to the wind down of financial contracts or other agreements… involving, or linked to [a list of prohibited bonds]" and "allows certain financial contracts and agreements… that involve or are linked to [those bonds] to be wound down, including resolving… swaps and derivative contracts in securities".

In the context of the Russia and Ukraine-related sanctions program OFAC also addressed[14] the issue of how non-sanctioned entities are expected to distinguish between transactions involving new equity and those involving old equity if sanctioned entities issue new equity that uses the same ISIN or other identifier as equity issued prior to the effective date of sanctions. OFAC stated that if a US person decides to transact or otherwise deal in equity issued by sanctioned entity prior to the effective date of the sanctions, the US person should ensure that it is not transacting in, providing financing for, or otherwise dealing in, the newly issued equity. If a US person does in

10 US Department of the Treasury, Office of Foreign Assets Control, General License No. 1B, Authorizing Certain Transactions Related to Derivatives Prohibited by Directives 1, 2, and 3 under Executive Order 13662 (November 28, 2017). General License 1B replaced and superseded General License No. 1A, dated September 12, 2014.

11 OFAC FAQ 372

12 OFAC FAQ 524

13 OFAC FAQ 662

14 OFAC FAQ 392

fact transact in, provide financing for, or otherwise deal in newly issued equity, such activity would constitute a violation of the prohibition.

7.6 Proposed approach

Non-sanctioned entities that have entered into Reference Transactions which reference underlying entities (or their obligations or instruments) that subsequently become sanctioned entities should be permitted to continue to enter into such transactions and perform their obligations under those transactions. Such performance should include the limited right of non-sanctioned entities to transfer prohibited new debt, equity or other instruments of the sanctioned entity to the extent necessary to enable the orderly settlement of those transactions in accordance with established industry processes.

A sanctioned entity referenced in a Reference Transaction is neither involved, nor directly affected by the existence of such Reference Transaction or the performance of the parties' respective obligations under that transaction. The sanctioned entity serves only as a point of reference for the parties to the Reference Transaction to perform their obligations. No direct obligations are ever owed to the sanctioned entity under Reference Transactions and the Reference Transaction does not confer any direct benefit on the sanctioned entity. Indeed, it is highly unlikely that a sanctioned entity would even be aware of any specific Reference Transactions beyond a general cognizance that a market exists in respect of transactions referencing it or its obligations (e.g., if it is a component of a credit derivatives index).

Theoretically, there could be some structures or transactions where the existence of a market in these Reference Transactions might indirectly benefit the referenced entity by positively affecting the liquidity of the underlying instruments that the entity issues. Any such theoretical benefit, however, should be carefully balanced against the greater risk of market disruption that could be caused by the uncertainty of parties being able to perform their obligations or hedge their liabilities under the Reference Transactions. As noted above, in the past regulators have considered these issues and determined that these types of Reference Transactions should be permitted and considered outside the scope of sanctions programs. A clear adoption and definition of this approach for future sanctions programs would help avoid potential disruption to the activities of non-sanctioned entities.

8. SPECIFIC ISSUES FOR CREDIT DERIVATIVES

8.1 Overview of a credit derivative

Credit derivatives are generally the type of Reference Transactions which reference an entity but not a single obligation of that entity. *Credit default swaps*, which account for the major share of the credit derivatives market, are written on a single reference entity or a basket or index of reference entities. One party (the protection buyer) pays the other party (the protection seller) a fixed premium for a *notional amount* of protection for a fixed period of time. The protection buyer receives a payment upon the occurrence of a 'credit event' with respect to the underlying reference entity. A credit event occurs with the bankruptcy of that reference entity or a failure to pay principal or interest on (or a restructuring of) certain debt obligations for which it is the borrower or guarantor. The obligations of the reference entity that can trigger the credit event are determined by criteria set out in the contract between the parties. These criteria are standardized for each different class of reference entity (i.e. by geographical region and entity type). The criteria are applied at the time of the relevant event (not at the time the trade is executed) and so the universe of potential obligations changes as old obligations of the reference entity are repaid and new ones are incurred. In addition, it is common (although not required) to identify a single obligation (the reference obligation) in the contract, principally to determine whether the transaction is referencing the senior debt or the subordinated debt of that reference obligation (as only obligations that rank at least pari passu with the reference obligation are included). The determination that a credit event has occurred is made by a Credit Derivatives Determinations Committee, which is tasked with making market-wide determinations in respect of standard *credit default swaps* and comprising representatives from *dealers* and buy-side firms.

Upon the determination of a credit event in respect of a reference entity, *credit default swaps* on that entity are settled either by means of either (i) a cash payment being made by the protection seller to the protection buyer reflecting the perceived loss on a principal amount (equal to the *notional amount* of the transaction) of certain obligations of that reference entity by determining the recovery price by means of a market-wide auction ('auction settlement') or (ii) at a party's election (or if no auction is held), by physical delivery of obligations of the reference entity ('deliverable obligations') by the protection buyer in exchange for receiving their par value ('physical settlement'). The deliverable obligations that may be valued in the auction settlement process or delivered in the physical settlement process are determined by reference to a narrower and standardized set of criteria than that used in determining the obligations that can trigger a credit event.

The auction is conducted in two stages. The first stage determines the open interest (i.e. the net supply and demand) for the deliverable obligations. *Dealers* participate in the auction by providing bids and offers on behalf of themselves and their clients, of which the difference is calculated as the net open interest. In the second stage of the auction, if there is a net open interest to sell, bids are submitted to buy the deliverable obligations; if there is a net open interest to buy, offers are submitted to sell the deliverable obligations. The final price used to determined the pay-out for the protection buyers is the price at which the net open interest is filled (i.e. the price where all the orders from stage one are matched with the orders submitted in stage two).

8.2 Issues relating to the entry into and performance under credit derivatives

Sanctions programs may prohibit any person from making funds or economic resources available, directly or indirectly, to or for the benefit of a sanctioned entity or prevent dealing in any property in which a sanctioned entity has any interest of any nature whatsoever, direct or indirect.

Such restrictions are extremely broad in scope and raise questions in respect of credit derivatives transactions referencing a sanctioned entity. As discussed above, a reference entity referenced in a *credit default swap* is not directly affected by the existence of that transaction (as it purely provides a point of reference for the non-sanctioned entities party to that transaction to perform their obligations by reference to). However, an argument might be made that in some circumstances or scenarios, the existence of a *credit default swap* market on a sanctioned entity may make it easier for such sanctioned entity to raise funds in the market, as a lender or bondholder outside of the jurisdiction of the relevant sanctions program will be able to hedge its risk to such sanctioned entity's creditworthiness by buying protection (making the a loan or bond a less risky investment).

Sanctions authorities should ensure that such an argument would not inadvertently prevent non-sanctioned entities from entering into and performing their obligations under *credit default swaps* on the sanctioned entity. Prohibitions on dealings in debt instruments in sanctions programs should negate any conceivable benefit to the sanctioned entity from such transactions. On the other hand, any inability of non-sanctioned entities to perform their obligations would create a great deal of uncertainty for non-sanctioned entities, including as to the application of the termination provisions under the *ISDA Master Agreement* and how they are to hedge obligations under transactions that are not subject to the sanctions programs. The situation would be greatly exacerbated in respect of sanctioned entities that formed part of a *CDS* index.

In light of the ambiguous nature of guidance given in respect of existing sanctions programs, it is important that the position in respect of these programs and any future programs be clarified to allow non-sanctioned entities to adequately assess and manage the risks of their trading activity.

8.3 Issues relating to auction settlement

The imposition of sanctions in respect of a reference entity may significantly increase the likelihood of a credit event occurring on that entity because of the restrictions on that sanctioned entity's ability to raise financing. By way of example, a credit event occurred with respect to Venezuela and PDVSA within months of the imposition of US sanctions on its debt obligations.

Where a sanctioned entity is a widely traded reference entity, it is likely that the relevant determinations committee would wish to hold an auction in respect of that sanctioned entity if it becomes subject to a credit event so that all triggered *credit default swaps* can cash settle in an orderly and consistent manner.

As discussed above, the auction settlement process provides for physical settlement of transactions formed in the auction. Without these physical settlement requests, the auction would not function.

Sanctions authorities should expressly permit the parties involved in the *CDS* auction process to hold auctions and permit non-sanctioned entities to participate in any such auctions and settle transactions by physical settlement. The *CDS* auction process does not convey any benefit on the sanctioned entity. There is no compelling reason for restrictions on the transferability of any affected obligations from one auction participant to another pursuant to the auction mechanism. The inability to hold an auction would cause the contracts to be subject to bilateral physical settlement which would create significant practical challenges and uncertainty as to the ability of protection buyers to deliver (or for protection sellers to receive) obligations of the sanctioned entity, causing a market bifurcation between entities that are subject to the jurisdiction of the sanctions and those that are not and disadvantaging the former.

9. REGULATORY CONFLICT ISSUES

9.1 Background

Economic sanctions may be issued unilaterally (such as the US sanctions on Venezuela introduced from 2017 or the unilateral reinstatement of the US sanctions on Iran in 2018), or on a coordinated basis (such as the US and EU Russia and Ukraine-related sanctions programs introduced from 2014).

Where sanctions are issued on a coordinated basis, the aims, approach, scope, individual targets and enforcement action can differ substantially between jurisdictions. For example, while both the EU and US Russia and Ukraine-related sectoral sanctions regimes limit the availability of new debt, the maturity limits under the US sanctions vary by sector whereas the EU apply the same 30 day restriction on all sanctioned entities. In addition, the EU regulations exclude payment and settlement services, including in the context of correspondent banking. More broadly, the US uses secondary sanctions whereas the EU does not.

Even in circumstances where sanctions are imposed by only one country, this can present compliance challenges. Notably, Article 5 of the EU Blocking Regulation[15] prohibits EU persons from complying (directly or indirectly) with any requirement or prohibition based on or resulting (directly or indirectly) from certain US sanctions targeting Iran and Cuba. As such, EU persons may face competing compliance obligations and risks under such US sanctions and the Blocking Regulation.

Challenges in compliance with conflicting sanctions regimes and approaches are not unique to derivatives. However, these issues are particularly acute in the derivatives market owing to the multiple jurisdictions' laws that may be relevant in any trading relationship, including the laws of jurisdiction of each counterparty (and its parent and/or guarantor), the governing law of the contract, the law of the jurisdiction where any collateral is held and the laws applicable to any underlying reference entity or asset. In addition, the largest global financial institutions are required to adopt global standards – if sanctions are adopted by one country in which they operate, they are obliged to comply with those sanctions globally or face exclusion from doing business in that country or other consequences. The cross-border nature of the derivatives market and the long-arm jurisdiction of national regulators over its largest actors create compliance challenges where actions required by sanctions programs unilaterally imposed by one country conflict with the laws and regulations of other countries that are directly applicable to those derivatives.

In addition, global standards on *regulatory capital* adequacy and the recent global regulatory reforms to the derivatives market introduced to address systemic risk impose obligations on financial institutions that may in certain circumstances conflict with obligations under sanctions programs. For example, if asset freeze/blocking sanctions programs were to restrict a non-sanctioned financial entity's ability to enforce *the close-out netting* provisions of the *ISDA Master Agreement* and/or the collateralization

15 Council Regulation (EC) No. 2271/96

arrangements, this could impact both the *regulatory capital* treatment of its derivatives transactions and its ability to comply with its mandatory *margining* obligations.

9.2 Proposal

As far as practical and within the legal framework of each relevant jurisdiction, sanctions authorities should ensure that where sanctions programs are imposed in a coordinated basis that the approach to derivatives is harmonized to avoid uncertainty.

Where obligations under specific sanctions programs might conflict with other sanctions programs or with other legal, regulatory or contractual obligations on non-sanctioned entities, as far as practicable regulators should ensure that such conflict does not arise or provide clear guidance as to how non-sanctioned entities are to resolve such conflict.

ISDA and its members recognize that sanctions authorities have different policy objectives and different tools at their disposal to implement those objectives in the context of economic sanctions programs. However, in furthering those objectives, sanctions authorities should seek to minimize the adverse economic consequences for the financial system.

GLOSSARY OF TERMS

Central counterparty or **CCP:** An institution that assumes the credit risk of derivatives by interposing itself as the counterparty to each side of a transaction entered into between two parties and that provides *clearing* and settlement services for trades in derivatives.

Clearing: The process of establishing positions in derivatives, including the calculation of net obligations, and ensuring that margin in the form cash or financial instruments is available to secure the exposures arising from those positions.

Close out: The exercise by a party to one or more derivatives transactions of a right to terminate those transactions prior to their maturity date pursuant to the terms of an *ISDA Master Agreement* following the occurrence of a prescribed event of default or termination event.

Close-out netting: The technique, enshrined in *ISDA Master Agreements*, used to determine a single net payment obligation in respect of all of the remaining contractual obligations under transactions that have been terminated or *closed out* under the *ISDA Master Agreement*.

Currency swap: A transaction in which one party pays fixed periodic amounts of one currency and the other party pays fixed periodic amounts of another currency. Payments are calculated on a *notional amount*. Such swaps may involve initial or final payments that correspond to the *notional amount*.

Credit default swap or **CDS**: A transaction in which one party pays either a single fixed amount or periodic fixed amounts or floating amounts determined by reference to a specified *notional amount* (the credit protection buyer), and the other party (the credit protection seller) pays either a fixed amount or an amount determined by reference to the value of one or more loans, debt securities or other financial instruments (each a “Reference Obligation”) issued, guaranteed or otherwise entered into by a third party (the “Reference Entity”) upon the occurrence of one or more specified credit events with respect to the Reference Entity (for example, bankruptcy, payment default or debt restructuring). The amount payable by the credit protection seller is typically determined based on the market value of one or more debt securities or other debt instruments issued, guaranteed or otherwise entered into by the Reference Entity. A CDS may also be physically settled by payment of a specified fixed amount by one party against delivery of specified obligations by the other party.

Dealer: An investment bank or other large financial institution that arranges and makes a market in derivatives transactions.

Derivatives: Financial contracts that are traded and negotiated directly between two parties without the involvement of an exchange or similar intermediary. They generally comprise swaps, forwards or options (or some combination of these), where payment or delivery obligations are determined by reference to an underlying published rate, price or index or the value or performance of an underlying asset.

End user: A derivatives counterparty that enters into derivatives transactions with a *dealer* in order to hedge its activities or to take a speculative position in a market.

Equity forward: A transaction in which one party agrees to pay an agreed price for a specified quantity of shares of an issuer, a basket of shares of several issuers or an equity index at a future date and the other party agrees to pay a price for the same quantity and shares to be set on a specified date in the future. The payment calculation is based on the number of shares and can be physically-settled (where delivery occurs in exchange for payment) or cash-settled (where settlement occurs based on the difference between the agreed forward price and the prevailing market price at the time of settlement).

Equity option: A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified number of shares of an issuer or a basket of shares of several issuers at a specified strike price. The share option may be settled by physical delivery of the shares in exchange for the strike price or may be cash settled based on the difference between the market price of the shares on the exercise date and the strike price.

Equity swap: A transaction in which one party pays periodic amounts of a given currency based on a fixed price or a fixed or floating rate and the other party pays periodic amounts of the same currency or a different currency based on the performance of a share of an issues, a basket of shares of several issuers or an equity index, such as the S&P 500 Index.

Foreign exchange forward: A transaction in which parties agree to buy one currency against selling another at an agreed price for settlement at a future date.

Interest rate swap: A transaction between two parties in which one party pays periodic amounts of a given currency based on a specified fixed rate and other party pays periodic amounts of the same currency based on a specified floating rate that is reset periodically; all calculations are based on a *notional amount* of the given currency.

ISDA Credit Support Annex: A standard form collateral agreement published in several forms by ISDA which enables parties to an *ISDA Master Agreement* to receive and provide collateral in order to reduce counterparty risk. In practical terms, the bilateral agreement establishes the day-to-day management of the risk, which involves computing the *mark-to-market* of the parties' exposure across all outstanding transactions and allowing the in-the-money party to make calls for collateral from the out-of-the-money party.

ISDA Master Agreement: A standard form framework agreement used by *dealers* and *end users* to govern their derivatives trading relationship published in several forms by ISDA, most notably the 1992 ISDA Master Agreement (Multicurrency – Cross border) and the ISDA 2002 Master Agreement. Each standard form *ISDA Master Agreement* is tailored to the specific requirements of the parties through the negotiation of certain amendments and elections in a schedule to the printed form but the core provisions governing the entry into, performance under and *close out* of transactions are generally not subject to any material amendments.

Lifecycle events: Actions that may be taken during the term of a derivative transaction which affect the rights and obligations of the parties under that transaction. Examples of lifecycle events include the exercise of any options, the rolling of an open position, material amendments to the term of the transaction, *novation* of the transaction to a third party, optional or mandatory early termination or portfolio compression (i.e. the replacement of multiple transactions with a singe transaction with the same economic effect).

Margining: The requirement on parties to a *derivative* periodically to post (by way of transfer or pledge) cash or other liquid collateral assets (such as government bonds) to each other to reduce the exposure that each party has to the other in the event that the party goes bankrupt or otherwise fails to perform its obligations. The amount of margin required is generally determined to be equal to the *mark-to-market* value of the *derivatives* (referred to as variation margin) with an additional buffer amount sometimes required to cover the potential volatility of the *mark-to-market* value of the *derivatives* (referred to as initial margin).

Mark-to-market: The periodic valuation of a derivative by reference to the price that *dealers* in the relevant market offer to enter into a replacement transaction on the same terms as that derivative.

Notional amount: The nominal amount of a derivatives transaction which is used to determine the parties' payment obligations, for example under an *interest rate swap* the fixed rate and the floating rate are applied to the notional amount to determine the periodic payment amounts.

Novation: The transfer by of one of the parties to a derivative of its position in that derivative to a third party. Novation generally requires the consent of the transferor, the transferee and the remaining party and is effected by written agreement.

Regulatory capital: The amount of capital a bank or other financial institution has to hold as required by its financial regulator. This is generally determined as a percentage of its risk-weighted assets and must be held as equity, reserves or certain other highly subordinated debt or hybrid debt/equity instruments.

Unhedged liabilities: Payment or delivery obligations of a party under derivatives or other instruments where there is no corresponding right under other arrangements to receive or obtain the relevant amount required to be paid or asset required to be delivered prior to the due date of that obligation of that party.

Voluntary unwind: The termination of a derivative prior to its scheduled maturity date either through mutual agreement of the parties, by exercise by one party of an existing optional termination right under the terms of the derivative or by the entry into an equal and opposite countertrade which cancels the economic effect of the original derivative.

ANNEX 1: OVERVIEW OF CERTAIN SANCTIONS PROGRAMS

The operative provisions of current sanctions legislation and regulation fall within several broad categories, all of which affect or potentially affect the derivatives markets. The focus of this paper is the United States, the European Union and the United Kingdom, but this overview applies generally to many other jurisdictions as well.

Assets Freezes/Blocking

Assets freeze provisions (sometimes also referred to as blocking) are a foundational tool of sanctions programs. Such provisions are present in a number of United Nations sanctions regimes, and as such they are a feature of national sanctions regulations around the world. Many individual countries maintain their own, lengthier lists of assets freeze targets (e.g., the US list of Specially Designated Nationals and Blocked Persons) that attempt to effect their own policy goals with respect to foreign relations, alleged illicit activity, national security and other matters.

Assets freeze provisions, in effect, prohibit persons subject to their jurisdiction from dealing with sanctioned entities in virtually any way. Those prohibitions take effect in various ways, but the most common is that they create violations when a person deals in the assets of a sanctioned entity or any assets in which the target has an interest.

Commonly, when a subject person comes into possession of the assets of a sanctions target, the person is obliged to "freeze" the assets, rather than return them to the sanctions target. Additionally, in some jurisdictions, assets freeze provisions require certain bodies (generally in the financial services sector or other regulated sectors) to report known dealings with sanctions targets.

Trade and investment restrictions

Many sanctions programs include limits on specific types of trade between subject persons and sanctions targets, the targets in this case ordinarily being countries or regions, and in a minority of cases particular individuals or entities. The most common limits are arms embargoes and other type of restrictions on defense-related trade: many UN sanctions programs include such provisions, and individual states also impose restrictions on trade in arms and related materiel. These restrictions take the form of sanctions or as export controls, depending on the jurisdiction and particular restriction at issue.

In addition, sanctions programs often target particular sectors, as a means of effecting the sanctioning country's foreign policy goals whilst limiting collateral damage to the target country's non-sanctioned population. Current and past sanctions regimes have targeted trade in oil and gas, petrochemicals, luxury goods, metals, currencies, automobiles, airplanes, rugs and other goods. Services rendered in support of such trade – including shipping, financing and insurance – are often also within the scope of these prohibitions. Restrictions on new investments in a particular country or region are still another variation on this type of sanction.

Restrictions on debt and equity transactions

With the Russia and Ukraine-related sanctions programs in 2014 came a new variety of sanctions provision, prohibiting dealings by subject persons in certain debt and/or equity of sanctions targets. These provisions target debt and equity created after the sanctions' effective date, thereby restricting targets' access to capital. Current debt-related prohibitions apply to debt the tenor of which exceeds a particular duration. "Debt" can, depending on the sanctioning jurisdiction, include payment terms that result in the extension of credit beyond the relevant maturity. As with other types of sanctions provisions, services associated with dealings in prohibited debt or equity are likewise prohibited.

Embargoes

Embargoes or near-embargoes on particular countries or regions are not common, but are a feature of a number of sanctions programs administered by the United States. The United States currently administers such broad "comprehensive sanctions" on dealings with Cuba, Iran, North Korea, Syria and the Crimea region. In short, persons subject to those embargoes are prohibited from dealing with persons located, resident or organized in the sanctioned locations and, typically, the governments of those locations, subject to few, narrow exceptions, such as humanitarian need.

Issues of Extraterritoriality

Sanctions regulations typically apply both on an *in personam* basis to citizens, nationals and legal persons of a sanctioning country but also to actions taken within the sanctioning country by persons located either within or outside of it. A highly relevant example of this is US enforcement precedent with respect to the use of US correspondent accounts and clearinghouses for dollar-denominated payments, as well as the UK guidance reflecting a similar principle for sterling transactions. Sanctions also often restrict the dealings of overseas legal entities owned or controlled by persons obliged to comply with those regulations.

Certain US sanctions – most notably those targeting Iran and Russia – contain elements that are extraterritorial. These measures – "secondary sanctions" – provide the US Government with means by which it can apply restrictive measures to persons outside of US jurisdiction in retaliation for certain activities associated with sanctions targets. For persons subject to the jurisdiction of EU member states, compliance challenges associated with such provisions are compounded by the EU "blocking regulation". In broad terms, the blocking regulation prohibits EU persons from complying with certain US sanctions. When the regulation was originally introduced in 1996, the relevant US sanctions covered related only to Cuba. However, the blocking regulation was updated in 2018 following the US's withdrawal from the JCPOA Iran nuclear deal to include several of the US sanctions programs with respect to Iran.

In addition, national laws can create compliance challenges. Section 7 of the German Foreign Trade Ordinance (*Außenwirtschaftsverordnung* - "AWV") prohibits German entities and nationals from complying with sanctions imposed by jurisdictions other than the UN, the EU and Germany. These rules were amended in 2018 to permit compliance where the UN, the EU and Germany have imposed sanctions against the same target even if the foreign sanctions programs are broader in scope. However, the possibility of future conflicts where the US and EU approaches diverge remains.