

Consensus building

The process of building the derivatives market has been a long and tricky one. **Elise Coroneos** looks at the role Isda has played in formalising the rules



In the early days of derivatives markets, very little could be taken for granted. Not in an industry that disagreed on basic questions such as the spelling of the very tools it traded. In those days, participants could be forgiven for believing they were trading a ‘swop’ rather than a ‘swap’. Such was the basic nature of the questions for which industry participants did not have answers.

In the interest of coming up with these answers, International Swaps & Derivatives Association (Isda) was formally incorporated in May 1985 in New York, made up of ten member firms. The first point of business for the new organisation was the Code of Standard Wording, Assumptions and Provisions for Swaps – or Code of SWAPS.

Today, more than 625 member firms in almost 50 countries put aside their competitive natures to come together through Isda to settle matters of culture, custom and practice in the dynamic and growing derivatives markets – which account for nearly \$240 trillion in notional principal of underlying assets. These members include most of the world’s major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on OTC derivatives.

While Isda is constantly working on ways to better the derivatives markets, certainly its most noted accomplishment has been the development of the Isda Master Agreement, the latest of which was notated in 2002.

“Before 1985, there was no standard documentation in the market,” says Paul Harding, the founder of Derivatives Documentation, a London-based derivatives documentation consultant and project management company. “Everyone got their law firm to produce documentation and they spent months and months arguing over it and in some cases never getting it signed up. Now that we have the Isda Master Agreement, while negotiations still go on, it is negotiation from a common format as opposed to lots of different types of agreements.”

Harding’s firm negotiates derivatives documentation on behalf of banks and other counterparties, typically when there is a backlog situation or when there is a prolonged absence of

senior staff. It also does in-house and online training for market participants in Isda and other documentation.

According to Jonathan Moulds, chairman of Isda and president, Europe, the Middle East, Africa and Asia at Bank of America, convening Isda is not so much a matter of competitors putting their interests aside, but rather competitors embracing their common interests for the betterment of the markets they all use.

“While our member firms compete in terms of market and product innovation, what they are interested in is a standardisation that allows that innovation to prosper. It creates places where people can then innovate around,” says Moulds.

A recent case in point

The strength of Isda was demonstrated in its development of the 2005 Novation Protocol, which was implemented last October. The Isda 2005 Novation Protocol came about because the volume of trade novation (assignment or transfer) presented challenges in fully adhering to the requirements of the Isda Master Agreement. Under the terms of Isda, parties need prior written consent before transferring a trade. However, due to the large volume of novations that are currently executed in the marketplace, some were at times being done without completely observing this consent, resulting in backlogs in confirmations.

“You had a high volume business that was also still growing and proceeding without fully following the terms of the Master Agreement. This could potentially have led to some legal uncertainty in the event of a bankruptcy or other change of status to one of the parties involved,” according to Katherine Tew Darras, assistant general counsel at Isda.

The Isda 2005 Novation Protocol set out a process by which the transferor, the transferee and the remaining party must communicate prior to, or concurrent with, a transfer by novation of a covered transaction and clarified that the effectiveness of the transfer between transferor and transferee is conditioned solely on receipt of the consent of the remaining party. In addition, the Protocol made clear that if by the end of the day on which the

transfer is agreed, the consent of the remaining party is not received or the remaining party withholds its consent, the transferor and the transferee will instead book a new trade between them. Finally, parties who adhere to the protocol commit to exchange a novation confirmation verifying the details of the novated trade.

Over 2000 institutions, from end user to dealer, signed up for a common approach to the novation issue. “The protocol mechanism provided a very efficient way of getting a large number of people to adhere to a change in practice. It is an example of the market identifying a potential problem and moving together to fix it,” says Darras.

The protocol mechanism was first used by Isda in the context of European Monetary Union (EMU). In the case of EMU, the protocol allowed participants to amend contracts that were written for disappearing currencies. “If you had many contracts referencing the French franc, without the protocol you would have had to go out and bilaterally get each of those counterparties to sign an amended agreement. Whereas, by sign-

ing the protocol, firms were able to submit one letter and all relevant deals between them and any of their counterparties that also adhered to the protocol were thereby amended,” says Darras.

Credit derivatives

One of the most contentious areas of Isda’s current work is in that of credit derivatives. In fact, many banks contacted for this story – JP Morgan, Deutsche Bank, Goldman Sachs and UBS – all initially agreed to be interviewed, but then shied away due mainly to their reluctance to be questioned on the area of credit derivatives. Obviously, it is a hot topic.

“There is a lot of focus in the credit derivatives space to ensure a lot of products are formally documented. It is a space that has grown larger than really anyone probably expected,” says Moulds.

Credit derivatives are definitely the area with the most ‘live’ projects, says Kimberly Summe, Isda’s General Counsel. “It is an area where there is a constant flow of new products or variations on existing products where the market can benefit and grow by the establishment of Isda documents. Perhaps the best example of this has been the growth of the CDS on ABS market, which almost immediately doubled in size after the development of the Isda template.”

One of the most ‘live’ of these issues is that of cash settlement. Specifically, what happens in the event of a default or a credit event with a credit default swap. Current market convention is for documented credit derivative trades to have a physical exchange of the bond upon the occurrence of a credit event such as bankruptcy or default. However, because of the popularity of the credit derivatives market, there have been a relatively limited amount of physical bonds to exchange in such an event.

“One of the most important things Isda is currently doing is to get the marketplace together to come up with a long-term solution to replace the physical settlement approach that is generally required under credit derivatives documentation,” says Summe. “First and foremost we provide a forum for firms from all sides of the market to come together to air their views and then work together on a solution.

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Quite often we are charged with taking that solution forward and enshrining it in documentation.”

What if something goes wrong?

The enforceability of its Master Agreements and Protocols is of prime importance to Isda in order to remain relevant to its members. As a result, Isda gets involved where there are proposed legislative changes affecting derivatives markets in countries around the world. In some cases their members may in fact be located in those countries or would like to do business in those countries. “We want to make sure the contracts between our members are enforceable if there is some kind of default,” says Summe.

To this end Isda is currently involved in consultations with public policy bodies in jurisdictions where there is potential for a privately negotiated derivatives industry, such as Russia. “We visit with government and other public policy makers, we provide comment on proposed legislation and work with them to facilitate a sound framework for the conduct of derivatives business. Further along in the process, we would commission an opinion that gives our members a legal view of the

enforceability of netting in that jurisdiction,” says Summe.

Isda has commissioned opinions on markets in about 40 countries – opinions, which are refreshed on an annual basis. As such, its geographical legal opinions are not designed to solve an issue after the fact, but rather to provide a basis upon which people can understand the legal enforceability. Some of Isda’s newest legal opinions are on markets in Poland and the Czech Republic.

Any disputes that arise are usually resolved via informal negotiations. “The drafting of derivatives documentation is an exhaustive process, but if by chance a mistake filters through to the final draft, people act reasonably to resolve the issue,” explains Derivatives Documentation’s Harding.

From the perspective of Bank of America, Moulds will only go so far as to say that any large firm from time to time has to deal with disputes, but that these are resolved where at all possible by mutual agreement.

In the event that there is disagreement over the provisions of the document and there are no agreed measures to resolve the issue, there can, from time to time, be litigation in the courts. “The problem would have to be momentous for legal action to be undertaken,” says Harding.

One such momentous problem did arise upon the demise of Enron, which generated a number of cases where the outcomes of derivatives documentation were contested in courts around the world. One such example was that of Enron Australia versus TXU Electricity in 2003. The result was that TXU managed to delay having to pay out Enron in closing because of Enron’s insolvency.

Isda does not get involved in disputes between two counterparties other than to provide briefs as a ‘friend of the court’ to assist the court in its interpretation.

On the drawing board

Isda has a number of projects that have recently come to fruition, such as the updating of its commodity definitions in 2005. “This is an essential piece of documentation for commodity derivatives and commodity underliers,” says Summe.

On the equities side, there are a number of ongoing documentation projects including that of definitions for

fund underliers such as a hedge fund or mutual fund, published on 15 March. “It is the first time we have published anything for that asset class,” says Darras.

In handling this project, Isda had to take many considerations into account, including the fact that hedge funds do not trade like other underliers, such as securities. “Whereas with a security, you have to take into account what happens if the exchange doesn’t open, for example, in considering the hedge fund asset class, we had to consider such things as what if something happens to the hedge fund manager, for instance what happens if they come under investigation by a regulator,” says Darras. “There are unique events to consider when it comes to hedge funds.”

Other work includes working towards the tightening of timeframes for transaction processing, closing confirmation backlogs, and minimising operational risk. On the first count of tightening of timeframes for transaction processing, Darras believes that there have been two main factors that have aided Isda in getting closer to its goal. They were firstly, the publication of its Operations Strategy Paper in 2003, which set forth broad plans for the market and tightening up confirmation processing timeframes, and secondly its work in Financial Products Mark-up Language.

In short, Isda’s role is one that will continue to grow as the market develops and complexity abounds. □

