FIXING THE PLUMBING

KIMBERLY SUMME OF ISDA AND **JEFFREY GOLDEN** AND **JOHN BERRY** OF ALLEN & OVERY EXPLAIN HOW ISDA'S LATEST PROTOCOL CAN HELP SOLVE DIFFICULTIES THAT WOULD OTHERWISE ARISE WHERE PRE-2002 ISDA DOCUMENTS ARE USED WITH THE NEW 2002 MASTER AGREEMENT

It is now more than half a year since the International Swaps and Derivatives Association (ISDA) published its 2002 Master Agreement, the successor to its 1992 Master Agreement (Multicurrency-Cross Border) (see *The Treasurer*, May 2003, p17). In that time, many participants in the over-the-counter (OTC) derivatives markets have been busy reviewing the new agreement and developing standard policies in preparation for using it.

PLUMBING ISSUES. Market participants probably realised early on that the use of certain documents published by ISDA before 2002 with the new agreement raises a number of issues. These arise simply because those documents were drafted not with the 2002 Master, but the 1992 Master in mind. They therefore contain references to the 1992 Master and terms and concepts contained in it, many of which are not contained in the 2002 Master. In that sense, there is a potential for 'leakage' (or at least points of friction) in ISDA's documentation pipeline when older documentation is used with the new core Master.

A good example can be seen in the 'mini close-out provisions' that are contained in several pre-2002 ISDA definitional booklets. These provisions set out a procedure for closing out a transaction if it is affected by a particular event or circumstance. For example, in the 1996 terms for equity linked derivative transactions, there is an elective provision that, if applicable, provides that the failure to deliver relevant shares upon exercise of a physically settled option transaction as a result of illiquidity in the market, will not trigger an event of default. Instead, this will result in the transaction being closed out with the 'loss' payment measure applying for purposes of determining any termination payment.

There are also several other provisions in ISDA's pre-2002 definitional booklets and credit support documents that provide for either a close-out of one or more transactions on the basis of the 'market quotation' payment measure, or the use of market quotation as a valuation measure for other purposes.

The difficulty is that both market quotation and loss are terms contained in the 1992 Master; neither concept has particular relevance in the context of the 2002 Master. Therefore, if parties were to use one of these pre-2002 documents with a 2002 Master unamended, there would be ambiguity. For example, if a court had to interpret a reference to loss in the 1996 terms for equity linked derivative transactions in the context of a transaction documented under a 2002 Master, it would need to consider a number of questions. Did the parties mean that loss, as defined in the 1992 Master, would apply, despite the fact that the transaction is governed by a 2002 Master and not a 1992 Master? Or did the parties mean that 'close-out amount' (as the successor to both market quotation

'ALL PARTIES CAN SELECT FROM A MENU OF STANDARD PROVISIONS' *JOHN BERRY, ALLEN & OVERY*

Figure 1

COMMON ISSUES

- 'ISDA Master Agreement' defined by reference to the 1992 Master.
- References to 'market quotation' and 'loss'.
- References to 'Termination Event' – do not reflect different valuation regime for 'illegality' and *force majeure* event.
- Definitions of 'confirmation' and references to 'applicable condition precedent' and 'termination currency' do not reflect changes in the 2002 Master.

Figure 2

DOCUMENTS COVERED

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

Figure 3

KEY FEATURES

- Forward-looking – no need to have already entered into a 2002 Master.
- Comprehensive coverage.
- Multilateral mechanism saves time and cost.
- Open until 1 March, 2004.
- Open to all market participants.
- Supported by legal opinions.
- Each trading entity must adhere.
- No effect on 1992 Masters.

'UNLIKE PREVIOUS PROTOCOLS, THE 2002 MASTER AGREEMENT PROTOCOL IS FORWARD-LOOKING' *JEFFREY GOLDEN, ALLEN & OVERY*

and loss in the 2002 Master) would apply? If the parties meant that close-out amount would apply, did they envisage that it would be determined in a specific way or would the standard definition in the 2002 Master apply?

As you might expect, there are other issues, many of which arise in more than one pre-2002 ISDA document (see *Figure 1*).

Of course, parties can address the issues in their confirmations and credit support arrangements. However, even if the parties could agree on an approach, addressing the same issues each time they enter into a transaction that incorporates the terms contained in a pre-2002 definitional booklet would be time-consuming and therefore costly. There would also be the risk that the parties would, on occasion, neglect to address the issues. Fortunately, then, the ISDA has provided another alternative for fixing the 'plumbing' and avoiding leaks as derivative traffic flows through the new 2002 Master: the 2002 Master Agreement Protocol.

ISDA PROTOCOLS. The protocol approach was pioneered in 1998, when ISDA published its European Economic and Monetary Union (Emu) Protocol to enable participants in the OTC derivatives markets to confirm its intentions with respect to certain issues arising as a result of the start of the third stage of European economic and monetary union (see *The Treasurer*, July/August 1998).

The key benefit of the protocol approach is that it enables each party signing on or 'adhering' to it to reach agreement with each other adhering party in one fell swoop, largely eliminating the need to enter into costly and time-consuming bilateral negotiations. Adhering parties are able to select from a menu of standardised provisions and, to the extent that the selections of any two adhering parties match, the selected provisions apply as between those two parties.

So helpful was the Emu Protocol that a total of more than 1,100 market participants adhered to it, including entities as diverse as the European Commission, Harvard University and McDonald's Corporation. Since 1998, ISDA has published other protocols, each of them until now designed to effect amendments to existing master agreements (or, in one case, credit support documents) between the parties. The latest protocol, however, takes the concept a step further.

THE 2002 MASTER AGREEMENT PROTOCOL. Unlike previous protocols, the 2002 Master Agreement Protocol is forward-looking. In other words, it contemplates that selected terms will apply not only with respect to 2002 Masters that have already been entered into between two adhering parties, but also with respect to any 2002 Master subsequently entered into between two adhering parties (whether before or after the end of the adherence period). This enables market participants who have yet to enter into a 2002 Master to take advantage of the limited opportunity to participate in the protocol.

To adhere to the protocol, all a party has to do is complete and sign a standard form letter indicating which of the 18 annexes containing standardised amendments it wishes to apply, produce a conformed copy of the letter (by typing in the name of the signing officers) and forward both copies, together with a cheque for $500 to ISDA's office in either New York or London. Where or to the extent that a party's selection of an annex matches the selection of another adhering party, the amendments contained in that annex will be deemed to be made whenever the relevant pre-2002 ISDA document is used in connection with a 2002 Master between them (whether then or in the future). Those amendments will not apply when the relevant pre-2002 document is used in connection with any other form of agreement between them, including a 1992 Master.

In addition to the multilateral mechanism it offers, and its forward-looking nature, there are a number of other benefits to recommend it to market participants. For example, the protocol itself and the standardised amendments contained in each annex result from widespread consultation among ISDA members and therefore reflect an industry consensus. It is also comprehensive, enabling parties to address the plumbing issues in a wide variety of pre-2002 ISDA documents (see *Figure 2*).

The ISDA website (www.isda.org) plays an integral role in the protocol process. A copy of the protocol is available there, together with a form of adherence letter and details of how to adhere. Also displayed there is a conformed copy of each adherence letter received by ISDA, together with a list of adhering parties, so that participants are able to keep track of adherence by other parties. This list also brings other benefits, particularly for early adherents. For dealers, it means they can advertise themselves as being in the position to do business under the new state-of-the-art Master. Customers, too, may reap benefits from being able to show dealers that they are ahead of the game and the cost of doing business with them will arguably be less.

A set of frequently asked questions (together with answers) has been compiled and also made available on the website to assist understanding of the protocol, the issues it addresses and the adherence process. Finally, the site displays supporting legal opinions on the enforceability of the protocol procedure under English law and New York law, each provided by Allen & Overy.

Market participants have until 1 March, 2004 to participate in the Protocol, although there is a mechanism allowing ISDA to extend the deadline slightly in appropriate circumstances.

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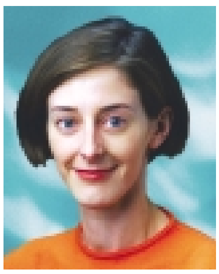

'ISDA'S WEBSITE (WWW.ISDA.ORG) PLAYS AN INTEGRAL ROLE IN THE PROTOCOL PROCESS' *KIMBERLY SUMME, ISDA*