

Compliance Corner

Negotiating and Renegotiating ISDA Master Agreements for Derivative Transactions

By Thomas V. D'Ambrosio*

While derivative transactions, including forwards, swaps and options, may be documented in a variety of ways, the standard documentation for such transactions is the Master Agreement published by the International Swaps and Derivatives Association, Inc. ("ISDA"). Both the 1992 and 2002 form of ISDA Master Agreement are currently in use around the world, with older versions having fallen out of use. The ISDA Master Agreement is a form contract which contains general provisions establishing a bilateral relationship for trading derivatives. Such form contains only the most general provisions, including those addressing payment obligations, basic representations, basic covenants, events of default, termination events, netting, close-out mechanics, gross-up obligations, expenses, notices, choice of law, choice of jurisdiction and waiver of immunity. The ISDA Master Agreement is customarily supplemented, amended and modified by the schedule and other related documents. Together, the ISDA Master Agreement form, schedule and related documents create an open platform on which parties can effect any number of derivative trades of various types in various asset classes, including equity, debt, credit, commodities, interest rates and currencies.

Negotiating an ISDA Master Agreement schedule in a few instances is a simple undertaking, usually in the case of simple interest rate swaps where one party has no bargaining power. More frequently (and almost always in the case of investment advisers), the negotiation process is a lengthy one. In the case of smaller investment advisers, the delay caused by negotiating an ISDA Master Agreement may be substantial. Although the negotiation process between highly motivated and available parties can be done within a week, the process in some cases may take more than a year. Delay results primarily from parties taking unique or aggressive positions and also from the fact that any number and type of derivative transactions may be effected under an ISDA Master Agreement, each of which presents a variety of issues. Accordingly, investment advisers who have a deadline to meet for derivative transactions should incorporate a delay into their timetable to accommodate the negotiation process. Of course, delays can be mitigated by having both legal and business personnel actively involved in the process.

Each type of derivative trade presents parties with unique issues, and the negotiation of an ISDA Master Agreement must take all of these issues into account. Regardless of type, however, all transactions require consideration of credit risk, legal risk and operational risk.

Credit Risk

Although sophisticated parties to derivatives transactions were always aware of the credit risk inherent in bilateral trading relationships, the insolvency and near insolvency of prominent financial institutions has raised awareness of credit risk, often referred to as counterparty risk. In order to properly address this risk, when negotiating ISDA Master Agreements, it is essential to understand the nature of the counterparty and its current and future ability and willingness to perform its obligations under the agreement. Provisions are customarily added to the ISDA Master Agreement in an attempt to mitigate credit risk, including those relating to early termination events, events of default, guarantees, escrows and collateral. Great care should be taken to not only review the ISDA Master Agreement in order to minimize credit risk but to analyze other contractual relationships between the parties, such as securities lending agreements, repurchase agreements, prime broker agreements, and loan agreements. The presence or absence of these agreements and other contractual relationships will alter the credit risk exposure of the parties.

Credit risk cannot be analyzed appropriately without an analysis of the insolvency laws which would apply in the event a counterparty becomes insolvent. Not only do different jurisdictions have their own unique insolvency laws, but even within a country the insolvency laws applicable to a counterparty differ depending on the type or nature of the entity.

Legal Risk

In addressing legal risk, the parties must assure themselves that they have a legally enforceable transaction, consider how the agreement for the transaction would be enforced if necessary and note any qualifications relating to its

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enforcement. Specifically, and not exclusively, the parties should address the choice of law which will govern the relationship, the authority and ability of the parties to contract, domestic and foreign laws that may affect the relationship and appropriate forums to determine the rights of the parties in the event of a dispute. In cases where a transaction must be effected prior to the negotiation of definitive documentation, parties need to determine the time by which a written agreement will be required and the penalties for not having a written agreement.

Advisers of investment companies registered under the Investment Company Act of 1940 as well as counterparties to such entities must understand how that statute affects not only the ability of registered investment companies to enter into a transaction but also the structure of the transaction itself. For example, the typical mechanism under which collateral is posted for an ISDA Master Agreement contemplates that collateral is transferred between counterparties. Yet under the Investment Company Act, a registered investment company generally is not permitted to post collateral directly to a counterparty. Conflicts between applicable law and the ISDA Master Agreement need to be addressed by legal personnel who understand the architecture of the ISDA Master Agreement and are able to adapt the architecture to suit the unique needs of a registered investment company. Similarly, advisers and counterparties to public and private pension plans must understand the laws and regulations affecting such entities, particularly the Employee Retirement Income Security Act of 1974 ("ERISA") and other laws which impose obligations substantially similar to those imposed by ERISA. Public pension plans are also governed by state statutes which may contain unique provisions and may raise enforceability concerns. Lastly, investment advisers and counterparties to insurance companies must understand the state laws under which insurance companies operate and the unique laws relating to the insolvency of such entities.

Although an ISDA Master Agreement is a bilateral contract, parties dealing with investment advisers will customarily ask the investment adviser to make certain representations and assume certain liabilities with respect to the investment adviser's client. Frequently, investment advisers are asked to accept greater risk than is appropriate for their role with respect to the client. As a result, negotiating the appropriate liability of an investment adviser should be expected and ample time allowed for that purpose.

Operational Risk

ISDA Master Agreements contain procedural details relating to the transfer of assets and provision of information. Information frequently requested includes financial statements and reports of net asset value. Personnel in charge of operations for the investment adviser and its client must be consulted about these provisions during the negotiation stage in order to ensure that the party (or the investment adviser on behalf of the party) can timely meet its obligations as contained in the ISDA Master Agreement. Additionally, such personnel must put operational systems in place in order to prevent defaults in obligations owed to counterparties and to ensure that contractual obligations are being fulfilled by counterparties, particularly with respect to the delivery of collateral.

Need for Monitoring and Revision

Because the negotiation of provisions related to the risks described above may be difficult as well as time consuming, parties who have successfully negotiated an ISDA Master Agreement are understandably reluctant to renegotiate the document. Major players in the derivatives market may have thousands of trades under ISDA Master Agreements which date back to the early 1990s (and in some cases earlier). However, neither markets nor counterparties remain unchanged over time. Therefore, it is imperative to periodically review ISDA Master Agreements which are in force in order to determine whether they continue to meet the needs of the parties. Between periodic reviews, ISDA Master Agreements should be reviewed carefully whenever entering into a new type of transaction or a transaction relating to a new asset class. Certainly, in light of recent events relating to the global financial crisis, there is a crucial need to review existing ISDA Master Agreements for credit risk and insolvency issues.

Conclusion

In order to successfully negotiate or renegotiate ISDA Master Agreements, it is important to balance the needs of both parties to the agreement and understand how those needs will develop over the duration of the transactions being contemplated. Such balance often requires analysis of complex arrangements and can be time consuming, but the parties who invest the time of both legal and business personnel will find that they are best positioned to achieve a desirable result in the least amount of time.

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