GUEST ANALYSIS: NEGOTIATING OVER-THE-COUNTER DERIVATIVE CONTRACTS

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Over-the-counter (OTC) derivatives contracts are much in the news because of the new financial reform act, "Dodd-Frank Wall Street Reform and Consumer Protection Act" (Dodd-Frank). This Act will change who regulates derivative contracts; who can and cannot trade these contracts; where these contracts can be traded and when they must be cleared; and how and when these contracts are to be margined or collateralized. Given all of these changes, it is important to keep in mind what Dodd-Frank will not change: how OTC derivatives contracts are documented and the importance of their careful negotiation. Indeed, it is now more important than ever that attorneys and corporate executives dealing with OTC derivatives not fall into the trap of viewing the documentation of these transactions as "standard," "routine," or "ordinary commercial contracting." Far from it.

Dodd-Frank will force many derivatives transactions onto exchanges where their non-economic terms will be fixed by exchange rules, but many more derivative contracts will continue to be traded OTC. And no matter how complex or "plain vanilla" the economic terms of those contracts may be, their non-economic terms will remain in need of focused and serious negotiation. In the "Questions and Answers" that follow, we discuss why careful negotiation of OTC derivatives transactions is so important and identify the key issues that need particular attention. Our aim is to dispel many of the common misunderstandings surrounding the OTC derivatives contracting process and give all users of derivatives a surer sense of how to approach the legal and contractual—as opposed to economic—complexities of these products.

Question:

Once my trading desk or department enters into an OTC derivative transaction with a dealer, that dealer generally sends us a set of papers that I am told are "standard industry forms." Are these forms "standard" and what should I do before authorizing their execution?

Answer:

Wholly apart from the economic terms of an OTC derivative contract—who pays whom what in the event of such and such—a large number of contingencies can affect the operation and outcome of such a contract. The derivatives dealer, as your counterparty, wants to be in the strongest possible legal position in the event of the occurrence of any of these contingencies. But, of course, if the derivatives dealer is in the strongest possible legal position then your company is in the weakest possible position. Thus, the forms the dealer sends are far from "standard" and before authorizing their execution they need to be carefully reviewed and negotiated by persons knowledgeable in derivatives contracting.

Question:

What exactly is included in the set of papers that a derivatives dealer sends in connection with my company's first OTC derivatives trade with that dealer?

Answer:

The "standard industry forms" that you are given most likely include an ISDA Master Agreement and an ISDA Credit Support document, both customized to the derivatives dealer's advantage (through the Schedule to the Master Agreement and the last Paragraph of the Credit Support document).

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Question:

The ISDA Master Agreement is a preprinted form. What is there to customize or negotiate?

Answer:

ISDA is the acronym for the International Swaps and Derivatives Association, a trade association with more than 820 member institutions from 57 countries on six continents. ISDA is active in a number of areas—lobbying for favorable legislation for OTC derivatives transactions, for example—but its most visible and best known activity is the development of standardized contractual terms and definitions for OTC derivatives transactions. To that end, the so-called ISDA Master Agreement is the key starting point for virtually all OTC derivative transactions.

But while the ISDA Master Agreement is, indeed, a preprinted form, it is designed to be negotiated and custom-tailored to the needs, circumstances, and expectations of the two counterparties (your company and a derivatives dealer). This means that an ISDA Master is never simply signed "as is"; there is always a Schedule attached to it that contains anywhere from a few to a great many changes to the "standard" agreement.

Question:

Is the same thing true of the credit support document?

Answer:

Yes. If either or both parties to a derivative transaction are required in any circumstance to post collateral, then another "preprinted" ISDA form -- one of the available Credit Support Annexes (or Deeds) -- will be used. But again, this collateral document is never signed "as is." Rather, it is supplemented and amended by an attachment (so called Paragraph 13 for the New York version and a similar attachment for the other Annexes and Deeds), which provides the substance of the collateral agreement.

Question:

Are any other documents likely to be included in the set of "standard forms" that are delivered to our company by a derivatives dealer?

Answer:

One more: the trade confirmation, reflecting the economic terms of your transaction with that dealer. Signing the ISDA Master and credit support document with a dealer does not commit your company to any particular transaction. The terms of each specific transaction must be set out in a written confirmation that your company is also expected to sign. Once the confirmation is signed (or the trade otherwise accepted), that confirmation becomes subject to and made part of the ISDA Master Agreement, and the entire set of documents is treated as a single agreement. Subsequent derivative transactions with the same dealer will require only further confirmations; and all such transactions will be subject to the original ISDA Master. Of course, if your company effects a derivatives transaction with another dealer, it will need to start over again and negotiate and sign new ISDA Master and Credit Support documents. But no matter with which derivatives dealer your company effects transactions, it will receive—and be expected to sign or otherwise acknowledge—a trade confirmation every time it enters into an OTC derivative transaction. It is the confirmation that contains the economic terms of each transaction.

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Question:

How can the ISDA Master Agreement be so complicated when it is a relatively short document, particularly when compared to my company's loan documents?

Answer:

Many of the terms in the ISDA documents are very complex. The ISDA Master Agreement is relatively short because these terms are generally defined in other ISDA documents, including various sets of definitions for different types of transactions. These definitions are or can be incorporated by reference. Unless the person in your company responsible for reviewing and negotiating derivatives documentation is quite familiar with all ISDA forms, definitions, and procedures, the contracting process can be quite confusing and perilous. Indeed, the financial and legal significance of the elections and additional provisions typically set out in the Schedule to the Master Agreement are likely to be lost on an inexperienced negotiator.

Question:

There are two versions of the ISDA Master Agreement: the 1992 version and the 2002 version. Does it matter which version my company is asked to sign?

Answer:

Although the 2002 Master has now been available for more than eight years, it has not entirely replaced the 1992 Master in the market place. Dealers generally prefer the 2002 version, while end-users generally prefer the 1992 version. With that said, the differences between these two forms of Master Agreements can be addressed in negotiations if your negotiator is knowledgeable about the differences and experienced in dealing with both versions of the ISDA Master. In other words, all issues can be raised and negotiated without regard to which form is selected as the starting point. Nevertheless, many end-users prefer to start with the 1992 version because it may allow them to avoid having to negotiate "away" many of the dealer friendly provisions in the 2002 version but not in the 1992 version.

Question:

Should my company's trading desk or department be allowed to effect OTC derivative transactions without there being a Master Agreement in place with our counterparty?

Answer:

There are many legal risks to trading OTC derivatives without a signed Master Agreement in place. Among them are, first, certain undocumented derivative trades may be unenforceable under applicable local laws. For example, the "statute of frauds" generally requires contracts that cannot be performed within one year to be in writing. Second, certain material provisions are not effective until the agreements are executed. For example, without a signed Master Agreement, the parties cannot rely on the tax gross-up provisions, and without a signed credit support document, guarantees, letters of credit, collateral requirements, and margin provisions are unavailable. Obligations to provide specified information may not be enforceable unless both are signed. Third, without a Master Agreement in place, if one party files for bankruptcy under U.S. law, the nonbankrupt party loses its ability to net all of its open trades with the bankrupt party. In addition, the bankruptcy trustee can "cherry pick" the open transactions with the nonbankrupt party; that is, the trustee can accept those transactions that are profitable to the bankruptcy estate while rejecting all other transactions. Further, without a signed Master, the nonbankrupt party has no right of set off; it cannot apply any cash, securities, or other property pledged by the debtor to satisfy amounts due from the debtor; payments received from the debtor before the bankruptcy filing may be required to be disgorged; and the nonbankrupt party has no right to cause the liquidation, termination or acceleration of open derivative trades. And fourth, when a Master Agreement is in place, transactions can be entered into by using simple, short trade confirmations rather than so-called "long form" confirmations that under any circumstance should themselves be carefully scrutinized and negotiated.

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Question:

What are the key of provisions in the ISDA Master Agreement that need to be negotiated?

Answer:

(1) Events of Default; (2) Termination Events; (3) Early Termination Date; (4) Payments on Early Termination; (5) Additional Termination Events; and (6) Calculation Agent.

Question:

What is an "Event of Default"?

Answer:

Certain occurrences that constitute "Events of Default" are set out in the ISDA Master Agreement. These occurrences can be left as is, deleted in whole or in part, or added to in the Schedule. Events of Default typically include: (1) Failure to Pay or Deliver; (2) Breach of Agreement; (3) Credit Support Default; (4) Misrepresentation; (5) Default under Specified Transaction; (6) Cross Default; (7) Bankruptcy; and (8) Merger without Assumption. Events of Default can be expanded in the Schedule beyond the counterparty itself by making them applicable to other "Specified Entities" (a member or members of a counterparty's corporate group) and to "Credit Support Providers" (a third party or parties that provide security for or guarantee a counterparty's liabilities).

If at any time an Event of Default with respect to one counterparty (Defaulting Party) has occurred or is continuing, the other counterparty (Non-defaulting Party) can -- for all outstanding transactions (upon not more than 20 days notice to the Defaulting Party) --specify the relevant Event of Default and designate a day (not earlier than the day such notice is effective) as an "Early Termination Date."

Question:

What is the significance of providing in the ISDA Master Agreement that a "Cross Default" is an "Event of Default"?

Answer:

This is a matter of great importance. Whether there will be (and if so the nature and scope of) a cross default provision is often one of the most heavily-negotiated points in a Master Agreement. If "Cross Default" is elected in the Schedule, there will be an "Event of Default" in the event the party to which the Cross Default applies "defaults"—even in a technical manner—on, for example, indebtedness to a third party for borrowed money in excess of the Threshold Amount (as set out in the Schedule), even if the third-party lender has not accelerated this loan. The parties can agree to replace "Cross Default" with "Cross Acceleration." In such a situation, a third party lender would have to actually accelerate the loan for there to be an Event of Default under the Master Agreement.

What is at stake when negotiating a cross default or cross acceleration clause is whether one (or both, but typically only one) counterparty's relations with its (and possibly its affiliates') credit providers will have a direct bearing on its derivative contracts. Hence, the negotiations will encompass not only whether there will be a "Cross Default" or "Cross Acceleration" at all, but if so, what definitions will be specified in the Schedule for "Specified Entity" (that is, which, if any, of the counterparty's Affiliates' defaults will "count" as an Event of Default) and "Specified Indebtedness" (that is, which, if any items of indebtedness for borrowed money will be carved out of Specified Indebtedness and/or which, if any, transactions beyond indebtedness for borrowed money will be included in Specified Indebtedness).

Question:

If my company is a hedge fund or other investment vehicle, is it "unusual" for purposes of Cross Default and Set-Off for my "Affiliates" to include the investment manager and all of my company's brother-sister entities?

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Answer:

“Affiliate” of a counterparty is defined in the Master Agreement—unless modified in the Schedule—as (1) any entity controlled, directly or indirectly, by that counterparty; (2) any Entity that controls, directly or indirectly, the counterparty; and (3) any entity directly or indirectly under common control (meaning ownership of a majority of the voting power of the entity or party) with the counterparty. However, in the case of an investment vehicle – just as for any other type of entity – it is advisable to avoid having classified as an “Affiliate” any entity that does not directly affect that counterparty’s financial condition, including credit worthiness.

Question:

What is the significance of a “Specified Transaction”? How is it related to an “Event of Default”? Specifically, can my company’s relations and transactions with third parties not involving borrowed money be included as a Specified Transaction?

Answer:

In a word, yes. Relations or transactions not involving borrowed money can and often are included within the definition of “Specified Transaction.” In this regard, there are important differences between the 1992 and 2002 Masters. Most significantly, repurchase transactions, buy sell-back transactions, and securities lending transactions, to mention a few, are included as Specified Transactions in the 2002 Master but not the 1992 Master. Obviously, this is one more reason end-users clearly prefer to start with the 1992 Master.

Question:

What is a “Termination Event”?

Answer:

A “Termination Event” is different from an Event of Default. It is an “Illegality,” “Tax Event,” or “Tax Event Upon Merger” and—if specified in the Schedule to be applicable—a “Credit Event Upon Merger” and an “Additional Termination Event.” If the event only affects one party, the Non-Affected Party has the right to designate the Early Terminate Date. If the event affects both parties, either party can designate an Early Termination Date.

The 2002 Master Agreement includes a “Force Majeure Event” as an additional “Termination Event.” If this Force Majeure provision is retained, any natural or man-made disaster, labor riot, act of terrorism, or other unanticipated event that prevents the performance of a party’s obligations under the contract is a Termination Event. Once a Force Majeure Event occurs, a party must show that the event is beyond its control and cannot be overcome by using reasonable efforts. Upon becoming aware of a Force Majeure Event, each party must use its best efforts to notify the other party of the event. After a waiting period of eight Local Business Days, a party can move to terminate the transactions affected by the Force Majeure Event.

Question:

What is an “Early Termination Date”? How is it different from an “Automatic Early Termination Date”?

Answer:

Upon a Default or Termination Event, an “Early Termination Date” is designated by the appropriate Party or Parties. Once this date has been designated, it can only be cancelled with the consent of both parties. If the Schedule specifies an “Automatic Early Termination Date” as applying to a Party upon a Default or Termination Event, then immediately upon the occurrence of such a triggering event, the termination date is fixed. The non-defaulting party does not designate this date.

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Question:

Is it common for a downgrade of a counterparty's credit rating to trigger an Early Termination? What are the possible negotiating positions?

Answer:

If the Schedule specified that a downgrade of a counterparty's credit rating by a specified amount constitutes an Additional Termination Event, then upon such a downgrade there would be an "Early Termination." As with any Early Termination, all of the counterparty's open transactions would be closed out (including its hedges, which, likely, would have serious adverse consequences for both cash flow and market exposure) and an Early Termination Amount calculated. Depending on the version of the Master Agreement used (or what was specifically negotiated), the Early Termination amount will be determined based on the methodology specified by "Close Out Amount," "Market Quotation," or "Loss." Derivatives dealers typically demand that their counterparties be subject to a ratings trigger to be certain they can close out contracts if there has been a deterioration in their credit worthiness. An end-user, on the other hand, obviously wants as much latitude as possible. Typically, an end-user can negotiate that a credit downgrade will trigger an Early Termination Event only if it constitutes a material adverse change in its credit worthiness.

Question:

Should the credit downgrade trigger run both ways?

Answer:

Absolutely, a dealer's creditworthiness is a key consideration in an end-user's decision to do business with the dealer in the first place. A credit rating downgrade trigger applied against a derivatives dealer can provide important protection for an end-user.

Question:

What are the differences between the various ways of calculating the Early Termination Amount?

Answer:

Upon an Early Termination, the 2002 Master provides a single valuation method, called "Close-out Amount." To determine Close-out Amount, the party valuing the Terminated Transactions (the "Determining Party") calculates its losses, costs, and gains with respect to the Terminated Transactions. In doing so, the Determining Party must consider quotations from third parties and relevant market data unless it reasonably and in good faith believes that quotations or market data are not readily available or would not produce results that meet ISDA-required standards. The Determining Party can consider other relevant information, including internally generated information. The Close-out Amount methodology imposes a good faith standard such that the Determining Party must act in a commercially reasonable manner and utilize procedures that produce commercially reasonable results. The Close-out Amount calculation is designed to impose a high standard of conduct on the Determining Party while providing flexibility for determining the value of Terminated Transactions.

By contrast, in the 1992 Master, the parties can elect either "Loss," where the Non-defaulting Party calculates its actual loss and costs, or "Market Quotation," where the Non-defaulting Party seeks quotations from leading dealers in the relevant markets. Of course, regardless of the version of the Master being used, the parties can negotiate the method of calculating the Early Termination Amount they wish to use.

Question:

What is the significance of "Set off"? To whom and how does it apply?

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Answer:

Set-off provisions are important in default situations because they allow the Non-defaulting Party to attempt to garner assets of the Defaulting Party in addition to amounts owed under the ISDA Master Agreement. With a Set-off provision, the Non-defaulting Party can determine whether there are other assets, such as deposit accounts, that can be attached and then set them off against the amount the Defaulting Party owes the Non-defaulting Party.

Although set-off rights have always been regarded as important, the drafters of the 1992 Agreement could not agree on language for a Set-off provision. As a result, the 1992 Agreement does not include a Set-off provision, and parties to a 1992 Agreement often negotiate a mutually acceptable Set-off provision in the Schedule. This practice became so common that the 2002 Master now includes a Set-off provision, and parties to a 2002 Master do not need to negotiate such a provision.

Question:

What is the Calculation Agent? Is it typical for the derivatives dealer to be specified as the "Calculation Agent"?

Answer:

The Calculation Agent, is specified in the Schedule and is responsible for the calculations and determinations with respect to all transactions governed by the Master Agreement. The Calculation Agent must act in good faith and in a commercially reasonable manner. Typically the dealer serves as the Calculation Agent.

Question:

If the dealer is the Calculation Agent, does the counterparty have any rights to object to its calculations and determinations?

Answer:

If the ISDA Master Agreement simply provides, without more, that the dealer is the Calculation Agent, then the counterparty has no right to dispute the dealer's calculations or determinations. In other words, there is no built-in dispute resolution mechanism. But, of course, a dispute resolution provision can be negotiated and included in the Schedule. Such a provision might provide that in the event of a dispute over a calculation or determination, the Calculation Agent must obtain firm quotations from independent dealers for the disputed calculation. Or, such a provision might provide that in the event of a dispute, each party will appoint a leading dealer in the relevant market. Their appointees would then select a third leading dealer, and the three leading dealers would collectively resolve the dispute.

Question:

Is it possible for a Master Agreement to be subject to the laws of one jurisdiction while the credit support document is subject to the laws of another jurisdiction?

Answer:

The law governing derivative contracts is quite significant. Most Master Agreements specify either New York or English law, although the laws of other jurisdictions are selected on occasion. Although it is not usually recommended, parties can enter into an ISDA Master governed by New York law while entering into a Credit Support Annex or Deed governed by English law, or vice versa.

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Question:

What is the significance of a derivatives dealer listing itself as a “Multibranch Party” and specifying all of its offices, wherever located around the world, as its branches? Should a counterparty be concerned about this?

Answer:

A party with branches or offices in multiple countries can designate itself as a Multibranch Party, and specify in the Schedule which of those branches or offices are authorized to enter into derivative trades with its counterparty. When dealing with a Multibranch Party, two key points should be kept in mind. First, the counterparty may need to receive additional tax representations and tax documents when entering into a transaction with one or another of the dealer’s foreign branches or offices. And second, foreign insolvency laws might come into play when transactions are entered into with branches or offices located in particular foreign jurisdictions. Typically, an end-user does not want to deal with foreign branches or offices unless it is entirely comfortable with the tax and insolvency laws in those foreign jurisdictions.

Question:

What is an “Independent Amount”? If no Independent Amount is specified in the credit support document, can it be specified in the Confirmation?

Answer:

An Independent Amount is an amount over and above the Credit Support Amount that a counterparty is obligated to post with the Secured Party. In such a circumstance, the Secured Party is basically holding excess collateral. Of course, if the Secured Party becomes insolvent, the counterparty risks losing its Independent Amount – as it is not a secured party with respect to that excess collateral.

An “Independent Amount” can be specified in a credit support document or in an trade confirmation. If an Independent Amount is provided in the credit support document, it is usually transferred to the Secured Party when or soon after the credit support document is signed or the first trade is entered into. However, because the Master Agreement provides that the terms of a Confirmation take precedence over the terms of the Master Agreement and credit support document, if a trade confirmation specifies an Independent Amount, that amount must be posted in accordance with the terms of the Confirmation. Because Confirmations can include new or unexpected terms that modify the Master Agreement, they must always be carefully reviewed.

Question:

What are the different ISDA credit support documents? How do they differ from one another?

Answer:

There are four ISDA credit support documents: the New York Credit Support Annex (New York CSA); English Law Credit Support Annex (English CSA); English Law Credit Support Deed (English Deed); and Japanese Law Credit Support (Japanese CSA). Even though the documents have similar names, the rights of the parties and degree of protection provided varies from agreement to agreement. As a result, careful consideration needs to be given to the specific form being negotiated.

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NEW YORK CSA

The New York CSA is (unless modified) a bilateral agreement, contemplating that either party to the Master Agreement might post and receive collateral as security for its derivatives transactions. The amount of posted collateral depends on one party's exposure to the other party. It is designated under the ISDA Master as a "Credit Support Document" that can be used to supplement and form part of the ISDA Master.

Parties to the New York CSA do not mark-up the pre-printed form. Instead, they note all modifications, elections, and additional provision in the attachment, called "Paragraph 13." In Paragraph 13, the parties specify the mechanics of posting and receiving collateral (for which there are no automatic fallback provisions); the types of collateral to be used; the valuation time; where cash can be held as collateral; whether posted collateral can be used, rehypothocated or pledged; the amount of exposure one party is willing to tolerate before requiring the other party to post collateral; and the interest rate, if any, to be paid on posted cash collateral.

ENGLISH LAW DOCUMENTS

Two different ISDA credit support documents are governed by English Law: the English CSA and the English Deed.

English CSA

The English CSA establishes (unless modified) a bilateral mark-to-market collateral arrangement. If adopted by the parties, it is made part of the ISDA Master Agreement. Rather than creating a security interest in the collateral, as happens with the New York CSA, the English CSA effects a transfer of title of the posted securities and cash collateral. Such an outright title transfer would be suitable for those parties that need to acquire ownership of the collateral they hold so they can use the collateral with other counterparties or in other transactions.

Under the English CSA, the secured party must return credit support that is "equivalent to" the credit support originally transferred to it. Equivalent credit support means an equivalent amount of cash and securities of the same series, denomination, and issuer.

Parties using the English CSA should be aware of tax and regulatory issues that can be associated with the outright transfer of title to collateral. If collateral is transferred, this may be a taxable "sale" that generates gain or loss, transfer taxes, or stamp taxes, depending, of course, on the tax jurisdiction of the credit support provider and the types of assets used as collateral. In addition, when the secured party transfers to the counterparty the equivalent of any income or distributions earned on the collateral, this payment may have adverse tax consequences for the secured party.

English Deed

The English Deed establishes (unless modified) a bilateral mark-to-market collateral arrangement, with the secured party receiving under English Law a formal security interest in the collateral. Structured as a deed, the English Deed simplifies the sale of collateral on enforcement. The English Deed does not give the party holding the collateral the right to use or rehypothecate the collateral prior to enforcement. Instead, it requires that non-cash collateral be held in a segregated account. The party posting the collateral retains title to the posted collateral. The parties can, if they agree, amend the English Deed to require that cash, as well as non-cash collateral, be held in a segregated account. The English Deed is a stand-alone document and is not made part of the Master Agreement although it is a Credit Support Document for purposes of the ISDA Master.

JAPANESE CSA

The 1995 version of the Japanese CSA provides for a bilateral security agreement using collateral (such as cash, deposit accounts, Japanese government bonds, or other readily marketable securities) located in Japan. Japanese law governs perfection and priority of security interests. The Japanese CSA was updated in 2008 to include Japanese netting, bankruptcy, and securities clearing system legislation implemented after 1995. The 2008 Japanese CSA provides for bilateral security and other credit arrangements. The 2008 Japanese CSA is a stand-alone

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document like the English Deed but governed by Japanese law. It is not incorporated into the Master Agreement but it is treated as a Credit Support Document for purposes of the ISDA Master Agreement.

Question:

Is the Credit Support Annex always a bilateral agreement?

Answer:

Dealers often (seek to) provide that the Credit Support Annex functions as a unilateral agreement under which the dealer is always the Secured Party and the end-user is always the Pledgor. The dealer can do this by making certain modifications in the Credit Support Annex. For example, in Paragraph 13 to the New York CSA, it can be noted that the term “Eligible Collateral” only applies to the end-user; the dealer is always the “Secured Party”; and the end-user is always the “Pledgor.” Another approach is for the dealer’s Threshold Amount to be specified to be “Infinity” or “Not applicable,” while the end-user’s threshold is a specified amount. In either case, the dealer would never be required to post collateral with the end-user but the end-user would be required to post collateral with the dealer once the end-user’s mark-to-market obligations exceed its Threshold.

Question:

If the Secured Party becomes insolvent, can the counterparty recover the cash collateral it has posted?

Answer:

Under the New York CSA, for example, a dealer, as the secured party or pledgee, has the right to rehypothecate and pledge all posted collateral free and clear of any incumbrances. The secured party thus receives an outright transfer of title to the posted collateral. As a result, the net amount owed to the pledgor by its insolvent pledgee is an unsecured debt.

This problem can be avoided by negotiating a provision in the CSA that collateral must be held by a third-party custodian. Further, it is also possible to negotiate a provision that prevents the pledgee from rehypothecating the collateral it is holding.

Question:

Under the New York CSA, what is “Eligible Collateral”?

Answer:

Eligible Collateral is specified in Paragraph 13 of the New York CSA. It usually includes cash or U.S. Treasury securities, but the parties can also agree to treat as Eligible Collateral direct obligations of U.S. government-sponsored entities (agency securities), corporate bonds, commercial paper, and “other collateral” as deemed acceptable to the Secured Party in its sole discretion.

Question:

What governs the haircut that the Secured Party can take on the posted collateral it is holding?

Answer:

In Paragraph 13 (typically in subparagraph (b)) to the New York CSA, the parties specify the items that will qualify as “Eligible Collateral,” which of the parties is permitted to post each item, and the haircut that will apply to each item. The Secured Party can only take the haircut that is so specified. Again, this is another item that needs careful negotiation.

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Question:

Under a Credit Support Annex or Deed, one party must post collateral if the total net mark-to-market value of all of its open positions fall below a certain Threshold amount. Is it typical that the other party would have to the same obligation and be subject to same Threshold Amount?

Answer:

No. Typically, the dealer will have a higher threshold number (possibly even infinity); such that it must be further out-of-the-money than the end-user before it is required (if ever) to post collateral. Of course, this is a matter for negotiation.

Question:

What is meant by "Threshold" in the New York CSA? How is this different from the "Threshold Amount" in the Master Agreement?

Answer:

"Threshold" is the amount set out in the Paragraph 13 for each party. A party is required to post collateral in the amount that its Exposure exceeds its Threshold. The Threshold can be any amount, from zero to billions of dollars to infinity. The Threshold should be a meaningful number that can vary (if agreed to in the Paragraph 13), depending on the credit rating or credit worthiness of the party.

"Threshold Amount," as used in the Master Agreement, is also a negotiated amount that is defined in the Schedule. It provides a dollar amount or percentage of a party's tangible net worth or net asset value that must be exceeded before there is an Event of Default with respect to Specified Indebtedness.

Question:

Should a counterparty agree to specified "Additional Termination Events," including "Material Adverse Change," if it has already agreed to a trigger based on a downgrade in its credit rating?

Answer:

In a word, no. A rating downgrade is an objective event outside of an entity (or its counterparty's) control. It should provide the counterparty with appropriate protection against adverse declines in the entity's credit worthiness.

In contrast, a Material Adverse Change can be triggered by a purely subjective determination by one party that there has been a material adverse change in the financial condition of the other party.

Question:

What is the Valuation Agent, and is it typical that the dealer be designed as the Valuation Agent?

Answer:

The Valuation Agent, as specified in Paragraph 13 of the New York CSA, determines the Value of Eligible Collateral, which is the amount of a specified type of collateral that is pledged or returned. The Valuation Agent also determines the Value (mark-to-market) of the Transactions which triggers the collateral requirement. On the Valuation Date, the Valuation Agent calculates the exposure and value of the collateral to be posted as of the Valuation Time.

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It is common for a dealer to want to be the Valuation Agent in all situations. With that said, the other party usually want the Valuation Agent to be the party making the relevant demand. If a party agrees to allow its dealer to be the Valuation Agent, at a minimum it should demand that if the dealer has an Event of Default or Additional Termination Event against it, then the other party would become the Valuation Agent in that circumstance.

Question:

Under the New York CSA, is it possible to dispute the Valuation of the Valuation Agent?

Answer:

Unlike the Master Agreement, where it is necessary to negotiate a right to dispute a calculation of the Calculation Agent, the New York CSA provides a dispute resolution mechanism in the event a party does not agree with the Valuation of Posted Collateral. The party disputing the valuation pays the amount that is not in dispute and the dispute resolution provision is triggered.

Question:

Is it possible to enter into a Shari'ah compliant OTC derivative contracts?

Answer:

In March 2010, a Shari'ah Compliant Master Agreement was jointly published by ISDA and The International Islamic Financial Market (IIFM). The ISDA/IIFM Tahawwut Master Agreement is intended for use with parties that want to enter into a Shari'ah Compliant Master Agreement. The Tahawwut Master can be used in all jurisdictions where Islamic financing is practiced. As with all ISDA Master Agreements, entering into the Master Agreement does not, in and of itself, give rise to a transaction. When entering into a specific transaction, the parties need to confirm that the terms of that transaction and any transaction specific credit support arrangements or amendments or additions to the Tahawwut Master are themselves Shari'ah compliant.

Under the Tahawwut Master, the parties agree that interest is not payable or receivable. Further, settlement is not allowed if it is based on validation or is without tangible assets. And, the parties represent to each other that they only enter into Shari'ah Compliant transactions. The parties must also confirm that each of their individual transactions is Shari'ah Compliant.

As with all other ISDA Master Agreements, governing law is either New York or English, as the parties elect in the Schedule. In its current form, the Tahawwut Master provides that transactions are limited to (1) actual transactions (murabaha transactions) and (2) undertakings or agreements to enter into a transaction in the future (subject to satisfaction of any condition).

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