End users that choose to enter into over-the-counter (OTC) derivatives to manage financial risks are confronted with a derivatives documentation package and negotiation process that may be unfamiliar and seem unduly complex. This guide is intended to provide a high-level description of the documentation structure for these transactions, significant regulatory considerations and commonly-negotiated issues to look out for. We hope this guide can help end users confidently approach this process however we encourage clients to consider engaging experienced specialist counsel who are familiar with the documentation and the issues involved.
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Documentation Structure

OTC derivatives, outside of certain market niches, are virtually always documented on market-standard forms published by the International Swaps and Derivatives Association (ISDA). The documentation is divided into two parts—the master documentation governing the overall trading relationship and the confirmation setting forth the economic details of an individual transaction.

The master documentation portion starts with a pre-printed form of ISDA Master Agreement—both the 1992 and 2002 forms are widely used in the market. The 2002 form contains tighter default triggers and a more flexible approach to calculating termination value, and as such is considered more favorable to the dealer than the 1992 form. The 2002 form is commonly the form offered by dealers for transactions with non-financial end users. The Master Agreement form itself is pre-printed and not changeable, so changes and elections are accomplished in the Schedule to the ISDA Master Agreement. If the trading relationship will include the transfer of financial assets as margin (because either the parties wish to secure the related credit exposure or the parties are subject to the Dodd-Frank margin rules), the dealer will generally provide a version of the ISDA Credit Support Annex (“CSA”) to be included in the documentation package. These documents collectively compose the ISDA Master Agreement (commonly just referred to as the “ISDA”) between the parties, which creates the basic structure of the legal arrangement (and, in particular, the credit and termination terms) that will govern their derivatives transactions.

The documentation of an individual transaction is accomplished on a “Confirmation”, which will ordinarily be sent by the dealer to the end user for execution shortly after a transaction is executed. The Confirmation will look more like a term sheet than a legal agreement, and will rely heavily on the relevant ISDA definitions booklet for definitions and common provisions. For rates and foreign exchange transactions, the Confirmation will typically reference the 2006 ISDA Definitions. The dealer should make a draft confirmation available prior to execution so that the end user or its counsel can review the terms and ensure that there are no post-execution surprises.

The ISDA documents referred to in this section are available for purchase at ISDA’s website (www.ISDA.org), and registered swap dealers are required to make the documents available to end users as part of their regulatory responsibilities.

A Note on Negotiability

Clients commonly ask whether there is any latitude to negotiate the terms of the ISDA documents that they’ve been offered by a dealer. This is fueled by a sense in the market (often encouraged by the dealers) that the agreements are market standard, mandated by regulation and not subject to negotiation. While there are bits of truth to this—certain parts of the agreements are truly standard, and rarely, if ever, negotiated—it is not wholly accurate. These documents, and particularly the credit and termination provisions, are often heavily negotiated and are more likely to be subject to negotiation where the end user is more financially sophisticated (such as a financial institution or hedge fund) or where it has more bargaining
power (a larger client of the dealer or a client contemplating a more significant transaction). Significant review and negotiation is more important for the end user where the contemplated transaction is intended to hedge a specific risk, such as an interest rate hedge for a variable rate loan, or where the combined transaction exposure is large relative to the overall financial risks of the end user firm.

**Internal Matters**

As an end user begins to consider entering into a derivative transaction, there are a few up-front issues we encourage them to consider. First, firms should sort out transaction approval and authority matters within their internal governance. While these instruments are important risk management tools, they also can have negative optics within and outside an organization (especially if the transaction loses substantial value) and therefore ensuring robust awareness and approval is an important first step. For smaller firms or larger transactions this may mean board presentation and potentially resolutions to approve the transaction. End user firms that maintain multiple legal entities will also need to consider which legal entity will enter into the transaction and whether any guarantees or other credit arrangements may be necessary based on that legal entity choice. At this step, legal counsel for the end user should consider whether there are any legal impediments within the organizational documents of the entity or in significant legal agreements (such as negative covenants in existing credit agreements). In some cases the latter may require waiver or approval by a lender. We also recommend clients engage their tax and accounting advisors as early as possible so that any necessary terms or limitations to consider can be incorporated into the negotiation.

Finally, end users will need to determine whether to engage outside counsel to negotiate the legal terms of the transaction and whether to engage consultants to advise on the pricing and other economic terms.

**Regulatory Considerations**

Clients contemplating derivatives transactions are often concerned about the impact of Dodd-Frank regulation on the transaction. While this is an important consideration, the incidence of the relevant regulation, and likely focus of regulatory review and potential sanction, is primarily on the dealer rather than the end user. However, there are several issues for the end user to look out for and consider.

The first and gating item is the limitation on participation. Dodd-Frank generally prohibits firms from entering into OTC derivatives with counterparties who are not “eligible contract participants“ or “ECPs”. This is a regulatory
designation that is a proxy for sophistication and financial risk-taking ability that is conceptually similar to (but distinct from) designations such as “accredited investor” in the securities context. For non-financial end users, ECP status is usually met by having at least $10 million in discretionary assets or (if the derivative is a hedging transaction) $1 million in net worth. While these tests are usually easily met at the group level for the types of firms that engage in OTC derivatives trading, ECP status needs to be met at the legal entity level and can create problems in situations where the end user would prefer to transact in a special purpose entity or affiliate entity that does not hold significant assets.

The affirmative obligations of the Dodd-Frank derivatives regulatory regime primarily apply to registered entities such as swap dealers. The regulatory obligations that will apply will therefore depend heavily on whether one or both parties to the trade is a registered dealer. Financial institutions that offer to enter into derivatives transactions will generally have been required to register as dealers, though in certain cases the institution may not have had to register if their dealing activity is limited in scope or amount to comply with one of several exclusions from registration.

Many of these affirmative obligations that apply to dealers have resulted in disclosures, representations and elections that are required to be incorporated into the derivatives documentation with their counterparties. As these requirements were originally being implemented following the passage of Dodd-Frank, the industry organized a standard documentation package to accomplish the necessary changes and track the required elections. These are the ISDA Dodd-Frank August 2012 and March 2013 protocols (commonly referred to as the Dodd-Frank Protocols 1 and 2, respectively). The public, multilateral protocol format allows market participants to adhere once and incorporate the content into all of their selected trading agreements with other adhering parties. Most dealers also maintain bilateral versions of these documentation packages that are substantively similar to the Dodd-Frank Protocols, for use by end users who do not wish to perform the public, multilateral protocol adherence. In either case, these regulatory documentation packages should not generally contain economically impactful legal terms; however they will include important representations
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enable review by regulators, as well as public reporting of certain anonymized economic terms of the trade. As a practical matter, in a transaction with a dealer, the dealer will be the reporting party and the end user’s only obligation will be to provide information in the regulatory documentation package noted above to facilitate that reporting. However, where neither party to the transaction is a dealer (a scenario that comes up more commonly in the commodity derivatives space) the parties may need to agree amongst themselves who will be the reporting party and include provisions or sign a separate agreement to that effect. The regulation also requires the usage of legal entity identifiers (“LEIs”) in reporting to have unique identification for the trading counterparties. LEIs can be obtained through market facilities, such as the Depository Trust and Clearing Company (DTCC) for the US market—though in practice dealers assign temporary identification numbers for counterparties who have not yet registered for an LEI.

The Dodd-Frank derivatives regulatory regime includes a recordkeeping requirement for all parties who engage in OTC derivatives—not just registered dealers—though the requirement is vague and not prescriptive as applied to end users, and end user recordkeeping does not appear to be an area of regulatory focus. We suggest clients preserve and maintain records of their derivatives activity in a manner consistent with how they would maintain records for other significant financial arrangements.

Finally, Dodd-Frank included anti-fraud provisions for OTC derivatives similar to those in U.S. securities law. We would not consider this to be a significant consideration for common types of derivatives activity engaged in by end users, though note that it does create a jurisdictional “hook” for review and enforcement actions by the CFTC or SEC (depending on the type of derivative).

Negotiating an ISDA Schedule

As we noted above in the section on negotiability, some provisions of the ISDA Master Agreement are commonly subject to negotiation while much of the document is rarely changed. The most commonly negotiated provisions are those dealing with credit and termination rights. The following are conceptual issues to consider for an end user negotiating an ISDA Schedule.

End User Credit Exposure — The terms of the ISDA Schedule offered will be influenced by whether the transaction results in the dealer having credit exposure to the end user. A swap will generally have the possibility of moving in value in either direction based on the movement of the underlying interest rate or other reference, and therefore the possibility of each party having credit exposure to the other. In contrast, an option transaction (such as an interest rate cap) will commonly be fully-paid upfront and therefore not involve the dealer taking credit exposure to the end user. In the former case, dealers may require security for the end user’s obligations, such as financial margin under a CSA, a letter of credit or, for
Termination Rights and Valuation – The ISDA Master Agreement includes Events of Default and Termination Events that allow one or both parties (depending on the event) to terminate the agreement and outstanding transactions, generally with the payment by one party of the net value of the transactions being terminated. In addition, ISDA Schedules often include Additional Termination Events, which are events other than the standard ISDA Master Agreement events and may relate to specific aspects of the trading counterparties or of the exposure being hedged. End users should carefully consider what scenarios should allow each party to terminate the transaction, as termination by the dealer takes away the benefit of the financial hedge as well as potentially requires payment of a termination value for the swap for which the end user may not have a ready source of liquidity. End users should closely review the content of the Additional Termination Events, as well as which party is specified as the “Affected Party” for such events—as that determines whether either or both parties is entitled to elect to terminate the transaction and calculate the termination value, as well as from which party’s perspective the replacement cost aspect of the valuation is determined.

Dealer Credit Exposure – In the end user context, the bulk of the negotiation will generally be about the dealer’s credit exposure to the end user; however, it is important to keep in mind the credit exposure that the end user may have to the dealer. While market participants gave this less consideration historically, it has received more attention following the failure of Lehman Brothers during the financial crisis. Depending on the context, market participants should consider this in regard to reciprocal credit provisions such as cross-default, or the application of dealer-specific events such as a dealer credit downgrade that triggers additional security obligations or termination rights. This also becomes more significant in the case (less common for end users) where the client is posting margin to the dealer, particularly where the margin posting obligation is greater than the mark-to-market valuation of the transaction—the overage generally referred to as initial margin or independent amount.

Note that in addition to the regulatory and onboarding documentation required by the dealer, ISDA Schedules will commonly include documents to be delivered by each party prior to execution, which may include financial statements, tax forms, resolutions demonstrating corporate authority and incumbency certificates for designated signatories. These documents should be obtained as soon as possible to avoid delaying the execution of the ISDA Master Agreement and potentially the execution of a transaction.
Negotiating a Credit Support Annex

The Credit Support Annex or “CSA” is an annex to, and part of, the ISDA Master Agreement, and is included where the parties wish (or are required by regulation) to transfer financial margin to secure their respective obligations under the ISDA Master Agreement. The specific form used will depend on whether the arrangement is satisfying a regulatory obligation and/or whether the agreements are subject to New York law or the law of a non-U.S. jurisdiction. The most important details to consider are the quantitative aspects of the obligation, including the Threshold for posting, the Minimum Transfer Amount, the Valuation Percentages for the allowable categories of margin and the payment of interest on margin in the form of cash. End users should also pay close attention to the mechanics of posting (notification and transfer deadlines), dispute rights for transaction or collateral valuation and how the collateral will be held (i.e. by the trade counterparty or at a third party custodian).

Reviewing the Transaction Confirmation

The confirmation setting forth the terms of the transaction will be produced and distributed by the dealer shortly after execution, for review and signature by the counterparty. This is the last step in the documentation process, however, parties can and should ask for draft or template confirmations without the final pricing terms filled in so that they can review and understand the provisions before executing the transaction. This is most important when the derivative is hedging a specific exposure, such as a loan, and the end user wants to ensure that the dealer has accurately aligned all the terms in the confirmation (Calculation Periods, Reset Dates, Business Day Conventions, etc.) with the corollary concepts in the loan agreement. Failing to do so could introduce basis between the derivative calculation and the interest payment under the loan. The other scenario where this is vital is where the parties have elected to include a non-standard term in the confirmation, such as a transaction-specific termination right, and reviewing and agreeing on language in advance decreases the possibility of post-execution surprises or disputes.

Conclusion

We hope this summary presents a helpful guide to end users navigating the derivatives documentation process. While this high-level summary of the issues doesn’t explain every point that will come up or nuance in the documents, it should give users a basic grounding in the regulatory and documentation concepts that will arise in the negotiation.