

Derivatives

Five Steps for Proactively Managing OTC Derivatives Documentation Risk

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Lehman Brothers' filing of a Chapter 11 petition in September 2008 sent both Lehman and its derivatives counterparties scrambling to find and make sense of the reams of documentation that governed their rights and obligations in the wake of that cataclysm. The bewildering challenge of terminating and valuing thousands of transactions was compounded by the fact that some counterparties could not promptly locate all of their documentation, and many of those that could were surprised – both negatively and positively – by what it contained when they read it.

The consequences of the Lehman bankruptcy are now in the rear-view mirror for most counterparties, but the market now faces other serious challenges. In particular, the OTC derivatives market is hurtling toward the brave new world of clearing, which will simplify some aspects of derivatives transactions, but not all of them. Not only are non-cleared transactions going to persist on a substantial scale, but many users likely will have a mix of both cleared and non-cleared transactions in their portfolios. This compounds the complexity of documentation of OTC derivatives, making it critical that market participants stay on top of their documentation.

Unfortunately, there are signs that many market participants may not be keeping pace in monitoring and managing all of the necessary details of their OTC derivatives portfolios. A January 2014 report on a counterparty exposure data collection program (begun in 2008) reports that large firms' "progress toward consistent, timely, and accurate reporting of top counterparty exposures fails to meet both supervisory

expectations and industry self-identified best practices." Another report indicates that market participants are struggling with collateral management – a critical piece of virtually all derivatives portfolios.

As so many counterparties learned from Lehman's bankruptcy, such disarray is a recipe for disaster. Only by keeping a close eye on documentation – both on the trading floor and in the legal and compliance functions – can problems be minimized or avoided, and opportunities exploited. There are a number of practices that OTC derivatives users of all sizes should adopt to manage the risks and to take best advantage of the opportunities presented by their documentation – and be well-prepared for any crisis, whether it is another major counterparty collapse like Lehman, or something more modest.

Step 1: Locate All Documentation

Among the primary intended virtues of clearing are standardization and simplification, but these will not apply to documentation. Prior to the advent of clearing, Dodd-Frank and other post-crisis reforms, the universe of relevant documentation would have included:

- Master Agreement;
- Schedule;
- Credit Support Annex;
- Paragraph 13; and
- Confirmations.

But a portfolio that includes cleared transactions will have all of these documents and potentially many new ones, such as the new Client Cleared OTC Derivatives Addendum and Annexes (leave it to ISDA to create an “Addendum Annex”), the basic form of which is fifty pages long. Also, many market participants entering the cleared marketplace likely will amend and update their basic documentation by adhering to various ISDA protocols regarding dispute resolution, valuation on close-out and so forth.

When Lehman Brothers filed for bankruptcy in 2008, many market participants scrambled to track down the documentation for their OTC derivatives transactions with Lehman – and some were still at it years later. As with most risks, the best approach to managing this problem is preparation and prevention: the time to assemble and take stock of derivatives documentation is not when a crisis or dispute arises, but well beforehand. The following are some steps users can take to proactively manage documentation risk:

- **Regularly inventory your documentation to be sure you have and can easily find all of the pieces, including both the standard forms and all amendments.** It is common for institutions with large OTC derivatives portfolios to save storage space (both physical and virtual) by keeping on file only the cover and signature pages of standard-form documents like the Master Agreement and Credit Support Annex. But that means that key provisions may be out of reach at a critical moment, and there is the possibility of pulling the wrong form just when it matters most. I remember well the confusion that ensued when a client that stored only cover and signature pages put the cover page for an English-law Credit Support Annex together

with the New York-law form. The mix-up could have led to serious problems as the two jurisdictions have some material differences in the way they treat swap collateral. Also, take the time to confirm that all documents are signed: some Lehman counterparties found that claims purchasers discounted the amount they were willing to pay for swap claims where the guarantees from Lehman’s parent were not signed.

- **Inventory and have available the documentation for any related transaction of which an OTC derivatives transaction may form a part – such as a loan or securitization.** The documents for *that* transaction are a necessary piece of the swap documentation. For example, where an interest rate swap is part of a rated securitization, the securitization documents may require notice to the relevant rating agency as part of a termination of the swap. Such a provision is every bit as critical as the provisions of the swap itself.
- **Keep individual trade confirmations easily accessible.** Again, it is common where a large portfolio is involved to store confirmations electronically or in a physically remote location. But in a crisis, they may need to be accessed within hours or even minutes, so there must be a way to locate and assemble them promptly – preferably in hard copy.
- **Know how to access – and download or print – electronically stored documentation.** Many users have turned to online platforms to exchange, manage and store confirmations and other OTC derivatives documentation entirely in electronic form. But in a dispute – particularly one involving a bankruptcy, lawsuit or arbitration or any other formal proceeding – it will be necessary to be able to export and produce documentation in paper form or at least an electronic

format that does not require access to a proprietary documentation platform. It is by no means clear that this will be straightforward: the earliest platforms for electronic confirmation of credit default swaps did not give users the ability to print or otherwise access all confirmation terms other than by looking at them on a computer screen. This meant that the terms of a trade could not be communicated to or accessed by outside counsel, produced in discovery, or provided to a court in a written submission. Even printed screenshots could not capture all of a trade's terms, and many terms were recorded only by reference to matrices of standard terms that were not always handy and were not accessible through the electronic platform. Some newer platforms have addressed a number of these shortcomings, but it is not clear that all of the bugs have been worked out, and those platforms that do provide for printing or exporting do not necessarily make it easy or straightforward.

Step 2: Prepare Markups and Summaries of the Documentation

Once the relevant documentation has been identified, located and inventoried, the sheer volume of paper involved in even a single trade requires that significant terms and amendments be digested in a readily accessible form. This can easily and efficiently be accomplished through a written markup and summary.

First, prepare a hand markup (yes, with a red pen) of the Master Agreement and the Credit Support Annex (and any other forms used) showing how they have been amended by the other pieces of the documentation, again, with citations to the locations of the amendments. Users that have mixed

portfolios of cleared and non-cleared transactions may find it useful to prepare separate markups to keep track of which amendments apply to which types of transactions. While users with multiple counterparties may find this task daunting, once completed, a markup does not need to be redone unless there are amendments to the documentation. In addition, the exercise of preparing the markup forces the preparer to become intimately familiar with the documentation.

Second, prepare a written summary with descriptions of and citations to the legally and economically distinctive or unusual provisions of the Schedule, Paragraph 13 and so forth. This summary ought to be kept handy by legal and compliance personnel as well as traders or other business people involved with a user's derivatives portfolio.

Properly done, both tasks can take considerable time, and they are especially difficult to carry out thoroughly and accurately in a crisis, when there can be pressure to develop a strategy for termination and close-out quickly. For this reason, it is advisable to prepare the markups and summaries at the time that the documentation is first executed. Ideally, each summary and markup also should be prepared by someone who is knowledgeable about the user's other derivatives documentation, so that provisions that diverge from that user's usual provisions can be identified easily and efficiently.

Step 3: Maintain a Legal Inventory

While trade data systems can be of some use in this regard, it is important to keep in mind that what a trader or other non-lawyer views as a "position" or a "trade" can differ significantly from what the ISDA documentation treats as a "Transaction," which is a defined term that refers to a single confirmation. What is a single Transaction for documentation purposes

nonetheless may be recorded in trading systems as either a single line item or many – a transaction with multiple “legs” or periodic payments commonly may be recorded using multiple line items to reflect actual economic risks or timing of cash flows. Again, when there is a crisis, reconciling line items in the trading system to individual confirmations is likely to prove both time-consuming and challenging. Accordingly, users should either keep a ledger that correlates individual Transactions – including the trade reference numbers of both the user and the counterparty – with the line items recorded in the user’s trading system, or include confirmation-level trade identifiers in their trading system so that trades can easily be sorted or filtered by confirmation. Electronic confirmation platforms also may be useful in tracking this information, provided they *make it easily accessible*.

Step 4: Conduct an Annual Documentation Review

An annual review of derivatives documents ought to be standard practice for every derivatives user. Although most derivatives users devote significant time, effort and money to negotiating ISDA documentation, once executed, it may not be looked at again for years, if ever. Among other things, an annual review provides an opportunity to incorporate changes in basic items such as notice addresses.

While minor details might not appear to warrant the effort of an annual review, keep in mind that Lehman had moved both its New York and London offices years before its September 2008 bankruptcy, but had changed the address for notices in few (if any) ISDA Schedules. As a result, Lehman’s counterparties that attempted to deliver notices pursuant to ISDA Master Agreements faced uncertainty as to whether delivery of such notices to Lehman’s new address would be treated as valid. Many counterparties ended up delivering

notices to Lehman’s old and new addresses in an abundance of caution, and anecdotes abound of messengers arriving at Lehman’s old offices in both New York and London to find the doors had been locked by panicked and overwhelmed security guards. One especially creative messenger is said to have duct-taped an envelope of termination documents to a building and photographed it with a smartphone to document the delivery. While Lehman does not seem to have made an issue of any of its counterparties’ deliveries, such a problem was the last thing those counterparties needed during that stressful time.

An annual review also should address more substantive issues such as changes or developments in applicable law or regulations. While the number of decisions in derivatives cases in both New York and England (the two primary jurisdictions for such cases) remains small, parties may find it desirable to “draft around” recent decisions that could negatively affect their relationship or their rights. One example of such a decision is *VCG Special Opportunities Master Fund Ltd. v. Citibank, N.A.*, 594 F. Supp. 2d 334 (S.D.N.Y. 2008), where the District Judge held that, under the circumstances of that case, VCG had waived the right to sue Citibank for an improper collateral call by continuing to post collateral. See “Growing Wave of Credit Default Swap Litigation: Judge Rules Citigroup Did Not Cheat VCG Hedge Fund on Swap and Trims Claims in VCG/Wachovia Litigation,” *The Hedge Fund Law Report*, Vol. 2, No. 31 (Aug. 5, 2009). In light of this decision, parties may wish to make even more explicit that the posting of collateral under protest or while a dispute is ongoing does not waive any claims or rights. Similarly, as part of the annual review, users should consider whether to adopt any new definitions, protocols, amendments or other such provisions published by ISDA in the preceding year and put in place a plan to address provisions that are anticipated in the year ahead.

As the market moves toward clearing of more and more transactions, users also will need to consider periodically how their documentation will work with both cleared and non-cleared transactions. The two types of transactions involve very different regimes for, among other things, margin posting, dispute resolution and early termination. Moreover, such differences mean that users with “mixed” portfolios must consider the potential risks flowing from the application of the two distinct regimes in the same market conditions. For example, it is much more difficult (some market participants would say impossible) to dispute a margin call for a cleared transaction than a non-cleared one. Will a user that meets a margin call on a cleared transaction (essentially involuntarily) based on a valuation the user disputes be treated as having consented to that valuation in a subsequent dispute about that margin call or a contemporaneous dispute over a similar margin call on a separate non-cleared transaction?

An essential caveat for the annual review is to be thoughtful and strategic about approaching counterparties regarding proposed amendments. Some counterparties may exploit a user’s proposal to make minor amendments as an opportunity to overhaul the documentation to the counterparty’s advantage – and the user’s disadvantage. Each user therefore should consider carefully whether a proposed change is worth the risk of inviting such an overhaul. It also is worthwhile to draft documentation so that ministerial changes – to addresses for notice, wire instructions and the like – can be made unilaterally so they do not give a counterparty an unnecessary opening to renegotiate substantive terms.

Step 5: Involve the Business in Documentation

Documentation has real economic significance and should be considered part of a business or investment strategy, not just a legal or compliance protocol. For example, a swap with a simple three-page confirmation containing only economic terms will behave – and must be treated – differently from

one with a twenty-page confirmation that includes bespoke contractual “outs” and other non-standard provisions. They cannot be treated the same, even if their economic terms are identical. While some of these types of risks ought to be managed before the confirmation is signed, long-dated transactions easily can fall off the radar screen if not subject to regular review.

Documentation is not just about risks – there can be opportunities as well. For example, if a termination event is triggered, that can provide an opportunity to terminate or renegotiate a trade that has become economically undesirable. But that cannot happen if the documentation for that transaction is locked in a file cabinet and never reviewed, or the business people do not know what it says.

Conclusion

These basic practices, if institutionalized and followed regularly, can help position OTC derivatives users to address disputes and crises quickly and with complete information. They also can help traders and other business personnel make more informed decisions, avoid triggering contractual outs inadvertently and unnecessarily, and take best advantage of opportunities to terminate or renegotiate transactions.

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