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Five Steps for Proactively Managing OTC Derivatives Documentation Risk: Checklist

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This Checklist provides a list of steps market participants can take with respect their to OTC derivatives documentation to protect themselves in the event of a major counterparty failure or other crisis, as well as to ensure they are in the best position to take advantage of opportunities presented by their derivatives activities.

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The filing of Lehman Brothers' Chapter 11 petition in September 2008 sent both Lehman and its derivatives counterparties scrambling to make sense of the reams of documentation that governed their rights and obligations under their portfolios of **over-the-counter (OTC) derivatives** transactions. The challenge of terminating and valuing sometimes thousands of transactions was compounded by the fact that some counterparties could not promptly locate all of their documentation. Those that could were often surprised by what it contained when they read it.

Market participants face the risk that they may not be keeping pace with 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) reported that large firms' "progress toward consistent, timely, and accurate reporting of ... counterparty exposures fails to meet both supervisory expectations and industry self-identified best practices." Another report indicated that market participants are struggling with collateral management, a critical piece of virtually all derivatives portfolios.

Only by keeping a close eye on OTC derivatives documentation, both on the trading floor and among legal and compliance personnel, can problems be minimized or avoided, and opportunities seized. There are a number of practices that OTC derivatives users of all sizes should consider adopting to manage the risks and take advantage of the opportunities presented by their documentation. These practices can help parties to be well prepared for any crisis, whether it is another major counterparty collapse like Lehman, or something more modest like a margin-call dispute.

This Checklist details the steps users can take to proactively manage their OTC derivatives documentation risk.

Step 1: Locate and Inventory All Applicable Derivatives Documentation

When Lehman Brothers filed for bankruptcy in 2008, many market participants scrambled to track down the documentation for their OTC derivatives transactions with Lehman (in some cases, this process took years). 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.

Prior to the advent of clearing, Dodd-Frank and other post-crisis reforms, the universe of relevant OTC derivatives documentation would have included the:

- [ISDA Master Agreement](#) (ISDA Master).
- [ISDA Schedule](#).
- [ISDA 1994 Credit Support Annex](#) (CSA).
- CSA Paragraph 13.
- Individual [transaction confirmations](#).

But a portfolio that includes cleared transactions includes all of these documents and potentially others, such as one of the new client cleared OTC derivatives addenda published by ISDA (see [Practice Note, ISDA Documents: Overview \(US\): The ISDA-FIA Cleared Derivatives Addendum](#)). This compounds the complexity of derivatives documentation, making it even more critical that market participants stay on top of it. 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 upon close-out and so forth.

Users should consider taking the following steps in this regard:

- **Regularly inventory derivatives documentation to ensure all of the component documents are available and readily accessible.** Be sure that all relevant derivatives documentation is readily available, including all standard forms (ISDA Masters), as well as all ISDA Schedules, annexes such as related CSAs and CSA Paragraph 13s, and transaction confirmations. 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 such as the ISDA Master and CSA. But that means that key provisions may be out of reach at a critical moment, and there is the possibility of pulling the wrong document just when it matters most. Also, take the time to confirm that all documents have been signed. Some Lehman swap 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. Counterparties may need to be approached about executing documentation that should have been executed at closing. It is best to do this before a crisis or other adverse development arises. It is therefore also important to account for related documents such as guarantees and [master netting agreements](#) that cover a party's swap documents.
- **Inventory and have available the documentation for any related transaction of which an OTC derivatives transaction may form a part.** This may include a loan or a securitization. The documents for such a transactions 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 agreement itself.

- **Account for all amendments.** Be sure to account for any applicable amendments to any of the documents that may have been effected during the term of the swap. It is common to miss amendments, since they are usually executed separately and at a later date than other transaction documents. As a result, they may be stored separately or otherwise difficult to identify. Post-execution amendments can often materially change the parties' rights under the documents so it is critical that they are accounted for.
- **Keep individual transaction confirmations easily accessible.** Where a large portfolio is involved, transaction confirmations are commonly stored 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. Many users have turned to online platforms to exchange, manage and store derivatives transaction confirmations and other OTC derivatives documentation entirely in electronic form. But in a dispute, particularly one involving a bankruptcy, lawsuit, arbitration or any other formal proceeding, it may 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. This is not always straightforward. The earliest platforms for electronic confirmation of credit default swaps did not give users the ability to print or otherwise access all of the transaction 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 screen shots could not capture all of a transaction'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 remains unclear that all of the bugs have been worked out. Platforms that do provide for printing or exporting do not always do so in an easy or intuitive manner.

Step 2: Prepare Markups and Summaries of Derivatives 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 available in a readily accessible form. This can be accomplished in two stages by preparing:

- **Hand markups.** These should show how the ISDA Master and the CSA (and any other forms used) have been modified by the other pieces of the documentation, with citations to the locations of these modifications (for example, the relevant ISDA Schedule, CSA Paragraph 13 or transaction confirmation section numbers). Users that have mixed portfolios of cleared and uncleared transactions may find it useful to prepare separate markups to keep track of which provisions apply to which types of transactions. In the alternative, documentation should be clearly marked to note whether it applies to uncleared (OTC) transactions only, cleared transactions only or both. 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.

- **Written summaries.** These should include descriptions of and citations to the legally and economically noteworthy or unusual provisions of the ISDA Schedule, CSA Paragraph 13 and so forth. For this reason, it is ideal for each summary and markup to be prepared by someone who is knowledgeable about the user's other derivatives documentation so that provisions that diverge from that user's typical provisions can be identified easily and efficiently. These summaries should be kept handy for all transactions in the user's derivatives portfolio by legal and compliance personnel as well as traders or other business people involved with the user's derivatives portfolio.

If properly undertaken, both tasks can take considerable time. They are especially difficult to carry out thoroughly and accurately in a crisis, when there can be pressure to develop a quick and efficient strategy for transaction termination and close-out under the documentation. Ideally, these markups and summaries should be prepared at the time the documentation is first executed.

Step 3: Reconcile Documents and Trading Systems

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 ISDA documentation treats as a transaction. The term "Transaction" is defined in the first line of the recitals to the ISDA Master by reference to individual transaction confirmations. 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 may commonly be recorded in trading systems using multiple line items to reflect the actual economic risks or timing of cash flows.

However, when a crisis arises, reconciling line items in the trading system to individual transaction confirmations can prove both time-consuming and challenging. Users should therefore either:

- Keep a ledger that correlates individual ISDA Transactions, including the trade reference numbers of both the user and the counterparty, with the line items recorded in the user's trading system. These may be incorporated into the hand markups discussed above.
- Include confirmation-level trade identifiers in their trading systems so that trades can easily be sorted or filtered by transaction confirmation. Electronic confirmation platforms also may be useful in tracking this information, provided the platforms make the information easily accessible.

Step 4: Conduct an Annual Derivatives Documentation Review

An annual review of derivatives documents should 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:

- Double check that all information provided remains correct.
- Incorporate any changes to basic items such as notice addresses. These amendments may generally be made unilaterally by parties to the ISDA Master without the need for a formal amendment between the parties. It is also 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 (as is the default under the ISDA Master).

While minor details might not appear to warrant the effort of an annual review, it should be kept 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) of its ISDA documents. As a result, Lehman's counterparties that attempted to deliver notices under their ISDA Masters faced uncertainty as to whether delivery of such notices to Lehman's new addresses would be treated as valid. Many counterparties ended up delivering notices to Lehman's old and new addresses out of an abundance of caution. 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. Proper delivery of notices is always important in an ISDA dispute.

This annual documentation review can also be considered an opportunity to 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 the UK (the two primary jurisdictions for these cases) remains small, parties may find it desirable to draft around recent decisions that may negatively affect their relationship or their rights. This would require an amendment to the ISDA Master.

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), in which the district court 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. In light of this decision, parties may wish to make even more explicit in their CSAs 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 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 OTC derivatives transactions, users will also need to periodically consider how their documentation works with both cleared and uncleared transactions. The two types of transactions involve different regimes for, among other things, margin posting, dispute resolution and early termination. Because of these differences, 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 an uncleared 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 or contemporaneous dispute over a similar margin call on a separate uncleared transaction with the same counterparty? Parties may want to clarify this in the documentation.

An essential caveat for the annual review is that it be conducted in a manner that is 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 that party's advantage (and the user's disadvantage). Each user, therefore, should consider carefully whether a proposed change is worth the risk of inviting a renegotiation on other points.

Step 5: Know Your Derivatives Documentation and Use it to Your Advantage

Documentation has real economic significance and should be considered part of a business or investment strategy, not just a legal or compliance issue. For example, a swap with a simple three-page transaction confirmation containing only economic terms will behave and should be treated differently from one with a 20-page confirmation that includes *bespoke* contractual outs, *additional termination events* (ATEs) or other non-standard provisions. Even if their economic terms are identical, they cannot be treated the same. While some of these types of risks should be managed before the transaction confirmation is signed, long-dated transactions can easily fall off the radar if not subject to regular review.

However, documentation is not just about risks. There can be opportunities as well. For example, the triggering of an Early Termination Event (see *Practice Note, The ISDA Master Agreement: Early Termination*) can provide an opportunity to terminate or renegotiate a trade that has become economically undesirable. However, if parties are unfamiliar with their OTC derivatives documentation, they will be unable to take advantage of these opportunities.

Conclusion

These basic practices, if institutionalized and followed regularly, can help better 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 inadvertently triggering ATEs.
- Take advantage of certain opportunities to terminate or renegotiate transactions.

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