Caroline Bradley

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SWAPS

Swap transactions have raised (and continue to raise) issues of novelty and of differences in the rules which may apply in different jurisdictions. A swap transaction is a transaction under which two parties agree to make payments to each other. The payments made by each party will be calculated by reference to different formulae. For example, in a simple swap one party may agree to pay interest at a fixed rate on a notional principal amount in return for interest at a floating rate on the same notional principal amount. Parties to a swap might agree to make payments to each other in different currencies. Swap techniques are evolving all the time: one example is the recent dramatic growth of credit default swaps.[1]

Swap transactions have raised numerous different legal issues ranging from issues about interpretation of the documentation to whether and how securities laws might apply to protect the interests of those who invest in swaps and lose money to the application of insolvency laws to swap transactions. In addition to specific issues which have arisen in relation to swaps in individual jurisdictions, swaps are often transactions which involve parties in different jurisdictions which may have different rules.

From **ISDA, Product Descriptions and Frequently Asked Questions** :[2]

9. What is a swap?

A swap is a privately negotiated agreement between two parties to exchange cash flows at specified intervals (payment dates) during the agreed-upon life of the contract (maturity or tenor). Entering a swap typically does not require the payment of a fee.

10. Product description: Interest rate swaps

An interest rate swap is an agreement to exchange interest rate cash flows, calculated on a notional principal amount, at specified intervals (payment dates) during the life of the agreement. Each party's payment obligation is computed using a different interest rate. In an interest rate swap, the notional principal is never exchanged. Although there are no standardized swaps, a plain vanilla swap typically refers to a generic interest rate swap in which one party pays a fixed rate and one party pays a floating rate (usually Libor).

11. Risks associated with interest rate swaps

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[1] A credit default swap allows a one party to the swap to obtain payment from the other party if a company or sovereign experiences particular financial problems (credit events) in return for fees. The credit default swap is similar to an insurance policy, except that the payor will make payment on the occurrence of a credit event whether or not the payee would in fact otherwise suffer any loss as a result of the credit event. *See*, *e.g.*, David Rule, *The Credit Derivatives Market: Its Development and Possible Implications for Financial Stability*, FINANCIAL STABILITY REVIEW, 117, 118 (June 2001) at http://www.bankofengland.co.uk/publications/fsr/2001/fsr10art3.pdf ; Louise Marshall, *Credit default swaps and the issue of restructuring: documentation, market practice and risk management*, Vol. 85, no. 8, RISK MANAGEMENT ASSOCIATION JOURNAL 32 (May 2003).

[2] http://www.isda.org/educat/faqs.html#9

Typically, a party entering a swap gives up (or takes on) exposure to a given interest rate. At the same time, each party take on the risk—known as counterparty credit risk—that the other party will default at some time during the life of the contract.

12. Suppose a client enters into an interest rate swap with a derivatives dealer to protect against rates rising by locking in a fixed rate. Doesn't that mean the dealer expects rates to fall? Otherwise, why would the dealer take on the risk of losing money?

The dealer's view on interest rates does not matter. When the dealer assumes a client's risk, the dealer typically lays off—that is, hedges—that risk with an offsetting transaction. Suppose, for example, a dealer enters into a swap in which the client pays a fixed rate to the dealer and the dealer pays a floating rate to the client. The dealer could hedge the risk by entering into an offsetting swap with another client or dealer. Or, it could take a Treasury security position with interest rate exposure that offsets the swap. Or, it could take an offsetting futures position. Over the entire portfolio some risks might be uncovered at various times—which is essential to the existence of a liquid market—but such risks are carefully monitored and controlled by dealers.

13. The value of an interest rate swap

The value of an interest rate swap to a counterparty is the net difference between the present value of the payments the counterparty expects to receive and the present value of the payments the counterparty expect to make. At the inception of the swap, the value is generally zero to both parties, and becomes positive to one and negative to the other depending on the movement of interest rates. Present value is the value of a quantity to be received in the future, adjusted for the time value of money (interest foregone while waiting for the quantity).

14. Credit risks associated with swaps

Loss on a swap occurs if two things happen: First, the counterparty must default; and second, the swap must have a positive value to the party that does not default. The amount of the loss depends on the credit exposure of the swap.

15. What is the actual amount at risk in a swap?

The credit exposure of a swap is the amount that would be lost if default were to occur immediately. Credit exposure is generally equal to the current market value if positive, and zero if current market value is negative. Swap participants also calculate future exposures of swaps, which are potential positive values during the life of the swap; future exposures are used to establish credit charges (expected exposure) and credit limit usage (peak exposure).

A swap transaction may represent a hedge on both sides or speculation on both sides or a combination of hedging and speculation. In one English case, Lord Templeman said: "The swap market enables a borrower to raise funds in the market to which the borrower has best access but to make interest and principal repayments in its preferred form of currency...Swaps may involve speculation or may eliminate speculation. In most cases the advantage sought by a user of the swap market is the elimination of speculation and uncertainty."[3]

One issue swaps raised in the US was whether they were subject to regulation by the SEC or by the CFTC (Commodity Futures Trading Commission). ISDA argued

[3] *Hazell* v *Hammersmith and Fulham London Borough Council* [1991] 2 WLR 372.

that they should not be regulated by the CFTC:[4]

Privately negotiated swap transactions have become an essential part of risk management for the American economy. Every day, companies, banks and governmental entities face unique financial risks—interest rates, currencies, commodity prices and securities prices. Users of swaps can manage these risks with swaps, which can be custom tailored to meet specific needs, but these users must have the legal certainty that the underlying contracts are enforceable in order to manage risk effectively.

Each attempt by the CFTC over the years to assert jurisdiction over swaps has created legal uncertainty. Congress should clarify once and for all that swaps are not subject to regulation under the Commodity Exchange Act (the "CEA"). Legal certainty has been aided by previous actions of Congress and the CFTC that recognized the unique nature of swap transactions, but the threat of legal uncertainty remains, as last year's issuance of the CFTC concept release showed. If clarification is not provided by Congress, the continuing threat of uncertainty will make it harder for firms to innovate, increase legal risk by undermining the enforceability of contracts, and potentially place these important hedging transactions out of the reach of many users.

Any legal uncertainty created by CFTC action is an outgrowth of the fact that the CEA is designed to regulate exchange-traded instruments only. The CEA is an inappropriate means for regulating privately negotiated swap transactions because they are fundamentally different from the standardized contracts traded on an exchange. In fact, applying the exchange-trading requirement of the CEA to swaps would render unenforceable thousands of outstanding swap contracts, representing billions of dollars of value to the American economy. The Treasury amendment recognized that financial contracts that are not traded on an exchange are not appropriately regulated as futures under the CEA. Off-exchange financial transactions common at the time the amendment was enacted (government securities and foreign exchange transaction) were excluded from regulation under the CEA. Although swaps were developed later, they are also off exchange financial transactions and should be excluded from regulation under the CEA.

ISDA believes that the best path forward is clear: provide the legal certainty needed for privately negotiated swap transactions and free the regulated exchanges to be more competitive. A clear declaration from Congress that swaps are not subject to regulation under the CEA achieves the first goal; a firm instruction from Congress to the CFTC to lighten the regulatory burden on the exchanges accomplishes the second goal. The result will be a combination of CFTC-regulated exchange activity that can more effectively compete in today's global marketplace and privately negotiated activity that can thrive without recurring episodes of legal uncertainty.

Any policy that increases the cost of swaps or reduces the flexibility and innovation that have been their hallmarks will hurt banks, brokers, corporations and governmental entities that use them to manage risk. Public policy should ensure the availability of a wide range of reliable and affordable risk management tools, both privately negotiated and exchange-traded, for the many users who can benefit from them. The competitiveness of American business, the success of the U.S. economy and the safety and soundness of the financial system will be

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[4] Statement of the International Swaps and Derivatives Association for the House and Senate Agriculture Committees' Futures, Derivatives, and Public Policy Roundtable Program February 25 and 26, 1999, available at http://www.isda.org/press/pdf/agsum222.pdf.

enhanced if Congress acts to ensure the reliability and affordability of these tools.

Congress subsequently enacted the Commodity Futures Modernization Act of 2000[5] which excluded many swaps from being considered securities. The CFTC has taken enforcement action in relation to contracts that it considered to be futures contracts, although they were described as swaps.[6] The CFMA mandated the Federal Reserve Board, the Treasury, the SEC and the CFTC to carry out a study on the subject of whether retail swaps should be regulated. The Report was published in December 2001 and did not recommend regulation of retail swaps:[7]

> A primary purpose of the CFMA was to create a clear legal foundation and regulatory framework for many types of over-the-counter ("OTC") derivatives transactions entered on a principal to principal basis between "eligible contract participants" ... Parties that do not qualify as ECPs include individuals who do not have total assets in excess of $10 million (or $5 million if they enter swap agreements for risk management) and non-financial entities that do not have total assets in excess of $10 million (or net worth in excess of $1 million if they enter swap agreements in the ordinary conduct of business or for risk management). For purposes of this study, non-ECPs are "retail customers," and swaps offered to them are "retail swaps."
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> Since its enactment, the CFMA has excluded OTC swap agreements and other specified derivatives transactions between domestic and foreign financial institutions, broker/dealers, insurance companies, commodities firms, and other ECPs from most of the CEA. The CFMA's limitation of this exclusion to ECPs was consistent with the recommendation of the President's Working Group on Financial Markets that OTC swap agreements between institutional counterparties generally should not be subject to the CEA....
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> Several interviewees noted that there was very little demand for interest-rate swap agreements at present except among institutions and high net worth individuals that already qualify as ECPs. For example, one firm remarked that, to the best of its representatives' recollections, it had never entered into fixed income swaps with an entity that owned or had under management less than $100 million in assets.
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> Some interviewees said that non-ECPs could potentially use interest-rate swap agreements to obtain the benefit of more favorable interest rates on household or small business expenses, such as mortgage or consumer debt, separately from the underlying loan. These interviewees added, however, that at the present time, it is convenient for non-ECPs to refinance a mortgage or transfer consumer debt, and the ability to enter into an "unbundled" swap agreement would not appear to offer retail customers a cost-effective or convenient alternative...
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> In summary, all but two of the interviewees reported that there does not appear to be significant demand for retail swaps at present, with one firm specifically stating that there was

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[5] See http://www.cftc.gov/files/ogc/ogchr5660.pdf

[6] *See*, *e.g.*, James E. Newsome, Chairman of the Commodity Futures Trading Commission, Address at the FOW Derivatives and Risk Expo, New York, (May 20, 2003), *available at* http://www.cftc.gov/opa/speeches03/opanewsm-39.htm .

[7] Joint Report on Retail Swaps (Dec. 2001) *available at* http://www.ustreas.gov/press/releases/docs/rss-final.pdf

retail interest in swap agreements with respect to energy products. The interviewees generally noted that retail customers currently have access to a wide range of derivative instruments and other alternatives to swap agreements to meet their financial needs, for example, for purposes of hedging or gaining exposure to particular securities or interest rates. To the extent that non-ECPs might seek to use swap agreements to protect against adverse price movements with respect to household or business expenses (e.g., interest rates, energy prices), several interviewees suggested that in most circumstances it would be cheaper and more convenient for non-ECPs to purchase such protection together with the underlying loan or commodity, rather than in a separate transaction.

The question whether swaps should be regarded as securities has arisen in the context of claims by parties who have found themselves on the losing side of swap transactions that they should be entitled to avoid the contracts or obtain a remedy. In these cases the party on the losing side may also raise arguments about fiduciary duties, negligent misrepresentations and frauds. An example of such a case is **Procter & Gamble Co. v. Bankers Trust Co.**[8] Here is an excerpt from the decision (the court held that the swaps were not securities):

This case involves two interest rate swap agreements. A swap is an agreement between two parties ("counterparties") to exchange cash flows over a period of time. Generally, the purpose of an interest rate swap is to protect a party from interest rate fluctuations. The simplest form of swap, a "plain vanilla" interest-rate swap, involves one counterparty paying a fixed rate of interest, while the other counterparty assumes a floating interest rate based on the amount of the principal of the underlying debt. This is called the "notional" amount of the swap, and this amount does not change hands; only the interest payments are exchanged.
In more complex interest rate swaps, such as those involved in this case, the floating rate may derive its value from any number of different securities, rates or indexes. In each instance, however, the counterparty with the floating rate obligation enters into a transaction whose precise value is unknown and is based upon activities in the market over which the counterparty has no control. How the swap plays out depends on how market factors change...
Those swaps transactions are governed by written documents executed by BT and P&G. BT and P&G entered into an Interest Rate and Currency Exchange Agreement on January 20, 1993. This standardized form, drafted by the International Swap Dealers Association, Inc. ("ISDA"), together with a customized Schedule and written Confirmations for each swap, create the rights and duties of parties to derivative transactions. By their terms, the ISDA Master Agreement, the Schedule, and all Confirmations form a single agreement between the parties...
P&G unwound both ..swaps before their spread set dates, as interest rates in both the United States and Germany took a significant turn upward, thus putting P&G in a negative position vis-a-vis its counterparty BT. BT now claims that it is owed over $ 200 million on the two swaps, while P&G claims the swaps were fraudulently induced and fraudulently executed, and seeks a declaratory verdict that it owes nothing...
P&G and BT were in a business relationship. They were counterparties. Even though, as I point out hereafter, BT had superior knowledge in the swaps transactions, that does not convert their business relationship into one in which fiduciary duties are imposed...
This does not mean, however, that there are no duties and obligations in their swaps

[8] 925 F. Supp. 1270 (SD Ohio 1996).

transactions.
Plaintiff alleges that in the negotiation of the two swaps and in their execution, defendants failed to disclose vital information and made material misrepresentations to it. For these reasons plaintiff has refused to make any payments required by the swaps transactions to defendants. Plaintiff requests that a jury verdict should declare that it owes nothing to defendants....
I turn to the statute law of New York. The Uniform Commercial Code, as part of New York statute law, particularly Section 1-203, states: "Every contract or duty written in this Act imposes an obligation of good faith in its performance or enforcement." New York has also adopted the principles in the Restatement (Second) Contracts, § 205, that every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement....
New York case law establishes an implied contractual duty to disclose in business negotiations. Such a duty may arise where 1) a party has superior knowledge of certain information; 2) that information is not readily available to the other party; and 3) the first party knows that the second party is acting on the basis of mistaken knowledge...
Thus, I conclude that defendants had a duty to disclose material information to plaintiff both before the parties entered into the swap transactions and in their performance, and also a duty to deal fairly and in good faith during the performance of the swap transactions....

The terms of a swap agreement are usually agreed orally with documentation following the agreement - first a written confirmation of the oral agreement followed by a detailed contract. Allen & Overy's Introduction to the Documentation of OTC Derivatives (2002)[9] states:

Although most parties intend the initial exchanges of terms letters or telexes and confirmations to constitute binding agreements, these initial agreements typically do not contain all the noneconomic provisions that most parties require for arrangements that may last as long as 10 to 15 years. These initial agreements do not set the general ongoing legal and credit relationship between the parties. For example, the confirmation letter or telex often does not include provisions covering representations and warranties, covenants, events of default, liquidated damages, assignment, judgment currency, consent to jurisdiction and closing documents. Such letter or telex also does not contain express provisions for the netting of swap payment obligations. These provisions, together with provisions covering the economic terms of a transaction, are normally contained in the master swap agreement (such as that produced by ISDA...) that incorporates the initial exchange of confirmation letters or telexes.

Baker & McKenzie describes the structure of the documentation as follows:[10]

The overall trading relationship between parties to OTC derivative transactions commonly is governed by an ISDA Master Agreement. The Master Agreement consists of a preprinted form published by ISDA, a Schedule of elections and modifications to the preprinted form, and any

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[9] http://www.isda.org/educat/pdf/documentation_of_derivatives.pdf

[10] Baker & McKenzie, Documentation of OTC Derivatives Under the ISDA Master Agreement: A Primer for Corporate Counsel & Treasury *available at* http://www.bakernet.com/NR/rdonlyres/923702A4-DA33-4050-B249-FD7605FF0885/0/SwapsPractice_asof11Sept04.pdf

other documents and agreements that the Master Agreement incorporates by reference. Although parties may enter into multiple Master Agreements with each other, each covering different transactions, companies that trade OTC derivatives solely for hedging purposes typically enter into only one Master Agreement with each of their financial institution counterparties. In that case, that Master Agreement governs all trade confirmations of OTC derivative transactions between those parties. The preprinted form Master Agreement contains provisions on the place for payments, netting of payments under multiple transactions, and tax gross-up, as well as standard representations and agreements. Most significantly, the form Master Agreement contains default and other termination provisions that enable a party to terminate all outstanding trades with the other party upon the occurrence of certain events. Further, the Master Agreement specifies how those trades are to be settled upon termination and when payments must be made. In January 2003 ISDA published the 2002 Master Agreement, which was designed to replace the old 1992 form. Although the 1992 form remains widely used, market participants are beginning to transition to using the 2002 form.

ISDA is a trade association which has been developing standard form documentation for the derivatives markets since the 1980s.[11] ISDA actively lobbies around the world for legislation which recognises netting,[12] and to persuade legislators and regulators not to introduce rules which would interfere with the operation of the derivatives markets (legal certainty arguments are frequent in this context).[13] ISDA also submits amicus briefs in litigation for similar purposes.

Netting raises issues in bankruptcy in particular. Bankruptcy laws may limit the effectiveness of contractual termination provisions, and may allow a liquidator to “cherry-pick” : “the liquidator could potentially decide to continue any transaction which is "in-the-money" for the insolvent party while repudiating any "out-of-the money" transactions.”[14] Here is an excerpt from a letter from ISDA to Argentina in 2001 urging

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[11] Sean M. Flanagan, *The Rise of a Trade Association: Group Interactions Within the International Swaps and Derivatives Association*, 6 HARV. NEGOTIATION L. REV. 211, 229 (2001) (“ The initial goal - and one of the key accomplishments of ISDA - has been the development, drafting, and promulgation of standard form documentation for the OTC derivatives industry.”)

[12] ISDA has developed a Model Netting Act.

[13] ISDA, Commission Action Plan on European Contract Law, (May 16, 2003) available at http://www.isda.org/speeches/pdf/commentscontract051603.pdf (“Enhancing legal certainty for cross-border financial transactions is one of ISDA's key missions. A considerable proportion of the resources of ISDA and its members are devoted to acquiring legal opinions from a wide range of jurisdictions on netting and collateral arrangements, and related issues, as well as promoting law reform and participating in consultations on legislative and regulatory developments affecting the financial markets. To the extent that the measures proposed in the Action Plan strengthen legal certainty for cross-border privately negotiated derivatives transactions, then clearly ISDA would support them.”).

[14] ISDA, Memorandum on the Implementation of Netting Legislation: A Guide for Legislators and Other Policy-Makers, 10 (Mar. 2006) *available at* http://www.isda.org/docproj/pdf/Memo-Model-Netting-Act.pdf

the enactment of netting legislation:[15]

Enactment of this legislation would promote legal certainty among international market players with respect to the enforceability of close-out netting in Argentina. In the absence of such legislation, central banks of leading jurisdictions have been unwilling to permit supervised credit institutions in their jurisdictions to net their exposures under OTC derivatives contracts with Argentine counter-parties for capital purposes. This raises the cost of derivatives transactions in Argentina and puts Argentine market participants at a competitive disadvantage. The approval of the Close Out and Netting Bill will allow foreign financial institutions to calculate their exposure with Argentine counter-parties on a net rather than on a gross basis. This will encourage foreign financial institutions to increase their credit lines to Argentine counter-parties. The Close Out and Netting Bill will bring Argentina in line with a number of jurisdictions around the world where foreign and local institutions benefit equally from netting legislation.

The US Bankruptcy Code recognises contractual netting:

11 USC § 560 Contractual right to liquidate, terminate, or accelerate a swap agreement
The exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind specified in section 365(e)(1) of this title or to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title. As used in this section, the term "contractual right" includes a right set forth in a rule or bylaw of a derivatives clearing organization ..., a multilateral clearing organization ...a national securities exchange, a national securities association, a securities clearing agency, a contract market designated under the Commodity Exchange Act ... a derivatives transaction execution facility registered under the Commodity Exchange Act..., or a board of trade ... or in a resolution of the governing board thereof and a right, whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice.[16]

Here is a description of how netting works in the context of ISDA agreements from William J. Bergman, Robert R. Bliss, Christian A. Johnson and George G. Kaufman, **Netting, Financial Contracts, and Banks: The Economic Implications**:[17]

An ISDA Agreement provides for numerous events of default. Events of default under an ISDA Agreement include, for example, failure to pay amounts due under a derivative transaction, a

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[15] https://www.isda.org/c_and_a/pdf/Argentina_netting_legis.pdf

[16] This provision was amended in the 2005 bankruptcy amendments (the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 Public Law 109-8 [S. 256] APR. 20, 2005).

[17] Federal Reserve Bank of Chicago, WP 2004-02, *available at* http://www.chicagofed.org/publications/workingpapers/wp2004-02.pdf

cross-default, and most importantly, insolvency (i.e., bankruptcy). A party is considered to be insolvent if, among other things, it is unable to pay its debts, makes a general assignment for the benefit of creditors, and seeks or becomes subject to the appointment of a conservator or a receiver. The appointment of a receiver or a conservator under FDIA would constitute an event of default under an ISDA Agreement. Upon the occurrence of an event of default, the non-defaulting party has several contractual and legal rights under an ISDA Agreement, including the right to terminate and close out an ISDA Agreement and the underlying derivative transactions.

As part of the termination and close-out of an ISDA Agreement, each included transaction is closed-out (i.e., terminated) at its mark-to-market value. To obtain the mark-to-market value of the relevant derivative transaction, the non-defaulting party will typically obtain three or four quotations for the contract from derivative dealers. If three quotations are obtained, the high and low quotations are thrown out and the middle quotation is used. If four quotations are obtained, the high and low quotations are thrown out and the middle quotations are averaged. The mark-to-market amount is usually equal to the cost of replacing the individual terminated transaction and is calculated without taking into account that the bank is insolvent. After the amounts are determined, each close-out amount will then be netted against the mark-to-market value of the other terminated transactions entered into under an ISDA Agreement. A net payment is then made at this time. The party that is out-of the- money is obligated under an ISDA Agreement to pay the net amount to the in-the money party, regardless of who is the defaulting party. If the insolvent bank is in-the money with respect to the net termination payment, such amount would be an asset of the insolvent bank and would be collected in full by the FDIC. The FDIC would then use these proceeds to pay off the different creditors in accordance with the depositor preference provision of FDIA. If the insolvent bank is out-of-the-money, then the solvent counterparty would be a general creditor of the insolvent bank (unless such amount was secured with collateral).