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The ISDA Schedule and Credit Support Annex

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Introduction

The International Swaps and Derivatives Association (ISDA) has developed a a standard suite of documents, which are applicable to all OTC derivative transactions, to enable parties to trade OTC derivatives without the need to negotiate and document each separate OTC transaction. The standard documents include:

(i) a Master Agreement;

(ii) ISDA Schedule (to the Master Agreement);

(iii) Confirmations;

(iv) Credit Support Annex (CSA); and

(v) ISDA Definitions

This suite of documents forms a single agreement and this concept is integral to the application of the ISDA Master Agreement and attempts to avoid what is commonly referred to as 'cherry-picking'. The single agreement concept means that all transactions form one contract, which provides counterparties with the ability to close out those transactions in the event of default and net the termination values to produce a single net amount payable between the parties.

This note will focus on discussing certain key provisions of the ISDA Schedule and CSA, but please see our publication entitled "Prime Brokerage and ISDA Agreements" for a general overview of prime brokerage documentation at: www.cummingslaw.com/publications.

Please note that any defined terms which are not defined in this note shall have the meanings attributed to them in the ISDA Master Agreement.

ISDA Schedule

The ISDA Schedule allows the parties to tailor the terms of the ISDA Master Agreement to suit their own particular requirements and circumstances. The following provisions in particular are often the subject of negotiation:

(a) Definition of Specified Transaction (Part 1(b))

The unamended definition of Specified Transaction means any OTC derivative transaction existing in another agreement between the counterparties or their Affiliates or Specified Entities (as specified in the ISDA Schedule). The 2002 Master Agreement expanded the definition of Specified Transaction from the 1992 Master Agreement to include repos and credit derivatives and the ISDA Schedule permits the parties to expand further, so as to include transactions with third parties, for example. Obviously, the wider the definition, the potential for an Event of Default (under 'Default under Specified Transaction') to be triggered is correspondingly broadened.

(b) Cross Default (Part 1(c))

Section 5(a)(vi) of the ISDA provides than an Event of Default will occur if a party (or its Credit Support Provider or any Specified Entity) defaults in relation to borrowed money (as such term is defined in Specified Indebtedness in the ISDA Schedule) under an agreement with a third party in excess of a specified Threshold Amount. This provision is often negotiated in the following ways:

(i) Cross acceleration – the cross default clause is effectively downgraded, such that the non-defaulting party to the third party agreement has to accelerate the indebtedness and take proceedings to terminate the third party agreement before the non-defaulting party under the ISDA is able to declare an Event of Default, allowing it to terminate the ISDA. This amendment is commonly resisted by most prime brokerage counterparties;

(ii) Administrative error carve out – this refers to carve-out language which is added to exclude payment delays caused by operational and/or administrative error from triggering an Event of Default provided such delay is remedied within a certain period of time, which can range between 1 to 3 Local Business Days. This carve-out is commonly accepted by counterparties, but is generally limited to 1 Local Business Day;

(iii) Expansion of definition of Specified Indebtedness – as with the expansion of the definition of Specified Transaction, the wider the definition, the potential to trigger an Event of Default under the Cross Default clause is broadened accordingly; and

(iv) Threshold Amount – the Threshold Amount sets the limit above which an Event of Default under Cross Default may be triggered. This can range from zero to a fixed sum of X million or, as is commonly the case, a fixed percentage of shareholders' equity or a fund's net asset value. This provision is commonly negotiated, as parties generally wish to avoid a de minimus or nominal amount triggering an Event of Default, but the amount will depend, of course, upon the bargaining power of the counterparties. In the case of a fund, the Threshold Amount may typically be set between 2% or 3% of the fund's NAV.

(c) Additional Termination Events (Part 1(h))

Section 5 of the ISDA Master Agreement provides a list of Events of Default and Termination Events and these can be supplemented in the ISDA Schedule to include Additional Termination Events (ATEs). ATEs are generally specifically tailored to the relevant counterparty and, in the case of a fund, will often include any one or more of the following:

(i) key person event i.e. death, departure or incompetency;

(ii) change in investment manager;

(iii) NAV decline over 1, 3, 6 or 12 months;

(iv) failure to report NAV;

(v) failure to deliver financial statements;

(vi) decline in assets under management;

(vii) change in investment strategy;

(viii)breach of investment restrictions; and

(ix) prohibited transaction under ERISA.

Breach of an ATE gives the counterparty the right to terminate, so a fund manager should ensure that it is not agreeing to a deadline in the ISDA Schedule, whether relating to the above or in general, which it is unlikely to be able to perform. The negotiation of ATEs for funds often centre on (iii) to (vi) (inclusively).

(d) Agreement to deliver documents (Part 3(b))

Part 3(b) concerns the delivery of non-tax related documentation and can often include delivery of a party's constitutional documents and, with regard to a fund, the fund's prospectus, investment management agreement, annual report and NAV statements. Negotiations generally centre around timing for delivery of the financial statements and, as mentioned above, it is important to agree to reasonable deadlines. Annual reports, for example, are often required to be delivered within 90 days, but it is common for the preparation of the accounts for a smaller fund to take at least 4 months, if not more. A further requirement often demanded of funds is an opinion of counsel, as well as a letter from the fund's process agent (which could be the investment manager, depending on its jurisdiction) agreeing to act as process agent.

(e) Netting (Part 4(i))

The ISDA Master Agreement provides for single transaction netting (i.e. the same Transaction in the same currency and due on the same date), but this can be amended in the ISDA Schedule to multiple transaction netting (i.e. more than one Transaction of the same type, in the same currency and due on the same date) or to cross-product netting (one or more Transactions of different types, in the same currency and due on the same date). It is therefore important in this case not to agree to do something which is not operationally possible.

(f) Other Provisions (Part 5)

Part 5 of the ISDA Schedule often includes a variety of additional provisions and these can relate to transfer of obligations, non-reliance provisions, representations and warranties and incorporation of other terms or agreements. In relation to funds, it is common for the fund to be required to make certain representations and warranties in addition to non-reliance, relating, for example, to the authority of the investment manager to act on its behalf or to US representations in respect of ERISA and FATCA. It is also common for the fund manager to be obliged to make additional representations and warranties, in addition to those provided by the fund, to the effect that it has the authority to act as the fund's agent and to provide indemnities in this regard to the ISDA counterparty, either in Part 5 or else in a separate side letter appended to the ISDA Schedule. It is questionable whether it is reasonable to seek additional warranties and/or indemnities from the fund manager to the extent that these have already been provided by the fund and it is quite common for the fund manager to resist any such obligation in this regard.

Credit Support Annex (subject to English law)

The CSA regulates collateral under the ISDA Master Agreement by defining the terms and conditions under which collateral is posted to mitigate counterparty credit risk. A CSA is not mandatory, but is usually required for fund counterparties. As with the ISDA Schedule, the CSA can be tailored and negotiated as appropriate, as types of permitted collateral, thresholds, minimum transfer amounts and margin can vary between counterparties. CSAs can be either unilateral i.e. only the weaker counterparty is required to post collateral, or bilateral i.e. either party may be required to post collateral.

The following provisions are often the subject of negotiation:

(a) Eligible Credit Support (Paragraph (b)(ii))

The parties are able to specify the form of eligible collateral that each may deliver as collateral and common forms are cash, US Treasury Securities and other major government securities with varying maturities. The list is not exhaustive and it is possible to include other debt obligations of other jurisdictions; however, varying haircuts apply, referred to as the Valuation Percentage, which can range between 0% for cash to 98% - 90% for G7 government securities with maturities between 1 and 10 years respectively.

(b) Independent Amount (Paragraph (b)(iii)(A))

The Independent Amount can be an initial amount which must be deposited by one counterparty with the other before any trading takes place or a sum which is callable after trading has taken place and is an indication of credit risk in respect of the relevant party. It is posted in addition to the daily variation margin requirements in the CSA. An Independent Amount may be either a fixed sum or a percentage of the notional amount of a Transaction.

(c) Threshold (Paragraph (b)(iii)(B))

The Threshold is the level of unsecured exposure each party will allow the other before any call for collateral is made. This is generally given as a fixed amount and can range from zero to X million. Where the Threshold is given as Infinity for one party, this is indicative of a unilateral CSA in the absence of any express provision in this regard.

(d) Transfer Timing (Paragraph (c)(v))

The standard CSA calls for collateral to be transferred the next Local Business Day, if the call is made before the relevant Notification Time (which can similarly be the subject of negotiation) or the second Local Business Day if made after the Notification Time. However, it is becoming increasingly common for this provision to be amended to provide for same day transfer if the call is made before the relevant Notification Time and the next Local Business Day if made after the Notification Time. Thus, as mentioned before, it is of paramount importance that a party agree only to what it is operationally capable of performing, as failure to transfer can give rise to a potential Event of Default.

Next Steps

As can be seen from the above, there are a number of issues to consider when entering or negotiating an ISDA Schedule and/or CSA. Cummings advises on and negotiates ISDA Schedules and CSAs, as well as other trading and brokerage documentation.

If you have any questions on the above or any ISDA documentation or would like to discuss this further, please contact Claire Cummings at:
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