Articles

'Targeted Touchdown' and 'Partial Liftoff': Post-Crisis Dispute Resolution in the OTC Derivatives Markets and the Challenge for ISDA[*]

By John Biggins[**]

A. Introduction

Since the 1980s, influential participants in the niche over-the-counter (OTC) derivatives markets have sought to encourage contractual standardization in the industry to mitigate the potential for unforeseen legal interruptions and ensure the enforceability of OTC derivatives contracts. The International Swaps and Derivatives Association (ISDA), a trade association and standard-setter, has spearheaded this effort; resulting in the creation and sustenance of a highly successful transnational private regulatory regime (TPRER).[1] Most notably, ISDA has generated a standardized boilerplate contract for OTC derivatives, known as the 'ISDA Master Agreement'. However, the TPRER within which the ISDA Master Agreement operates displays some intriguing features and paradoxes. Chief amongst these paradoxes is that, while this TPRER appears at first glance to be highly legalistic and formal, indications are that rates of formal litigation between members of the regulatory regime have traditionally been low[2] relative to the size of the market (the total notional amount of

[*] This paper is based on a presentation of the Fifth CLPE Conference at Osgoode Hall Law School in Toronto, 1-2 March 2012, entitled "Transnational Private Regulatory Governance: Regimes, Dialogue, Constitutionalization". I am very grateful to participants for useful discussions. This paper draws from a larger case study with which the author was involved at the University College Dublin Centre for Regulation and Governance from September 2010 to October 2011 entitled 'Regulating OTC Derivatives for Better Corporate Governance'. That case study formed part of a broader research initiative led by a consortium of universities, including UCD, entitled *Transnational Private Regulation: Constitutional Foundations and Governance Design*. The broader initiative enjoyed support from The Hague Institute for the Internationalization of Law (HiiL) [http://www.hiil.org/]. The author gratefully acknowledges the support of HILL, Colin Scott, Blanaid Clarke and other researchers on the HiiL initiative, as well as the contributions of a number of anonymous interviewees in the broader research. Any views expressed in this paper, the broader case study, as well as related papers and materials are the personal views of the author alone and do not necessarily represent the views of any other individual or organization to which the author is affiliated. Errors and omissions are also the authors' alone. This draft was largely completed in February 2012, with certain revisions in November 2012, and is not reflective of subsequent developments.

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[1] For broader discussion of TPRERs, *see* e.g., Colin Scott, Fabrizio Cafaggi & Linda Senden, *The Conceptual and Constitutional Challenge of Transnational Private Regulation*, 38 J. OF L. & SOC. 1 (2010).

[2] ANNELISE RILES, COLLATERAL KNOWLEDGE: LEGAL REASONING IN THE GLOBAL FINANCIAL MARKETS 30 (2011) [hereinafter "Riles (2011)"].

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OTC derivatives contracts outstanding at the end of 2011 was estimated at US$648 trillion).[3]

While instances of high profile litigation have increased noticeably in the wake of the global financial crisis (GFC), most visibly in relation to the bankruptcy of Lehman Brothers, it is apparent that ISDA is actively seeking ways to minimize such occurrences. This may be largely because, intuitively, the role of national public courts in ensuring enforcement of an otherwise private regulatory standard presents a dilemma for OTC derivatives market participants. ISDA has limited control over the way public courts choose to interpret and enforce the TPRER and, as a result, this generates uncertainties for the private regulatory regime as a whole. Accordingly, despite the best efforts of ISDA and the industry to minimize 'interpretative interference'[4] through what I term 'targeted touchdown' (drawing on the work of Robert Wai) of disputes in what are perceived to be 'derivatives friendly' jurisdictions, particularly England and New York, such interference has been unavoidable.

ISDA's preference for litigation to be limited to certain courts is not a new development *per se*, or unique to the OTC derivative industry either; however the limitations inherent in this strategy are obvious to ISDA, and are perhaps even more obvious in the wake of the GFC. Hence, ISDA's strategy in the wake of the GFC has more readily embraced alternative dispute resolution (ADR). In particular, it is notable that ISDA has been highly supportive of the establishment of a new ADR mechanism, the Panel of Recognized International Market Experts in Finance (PRIME Finance), which has been at least three years in the making. Nevertheless, it not clear that ISDA's increased appetite for ADR, including PRIME Finance, will be sufficient, in and of itself, to keep OTC derivative disputes out of the public courts, for reasons which have been illustrated elsewhere and will be re-illustrated in this paper.

It is recognized that public regulatory reform in the OTC derivatives markets is ongoing at time of writing and could also be thought of as another way in which public actors/processes could interfere with private norms in the OTC derivative markets. However, that dynamic is not the primary focus of this particular paper. Nonetheless, in order to provide necessary context the broad contours of OTC derivative market reform

[3] Bank for International Settlements, *OTC Derivatives Statistics as at End-December 2011* (May 2012), available online at: http://www.bis.org/publ/otc_hy1205.pdf (last accessed: 1 December 2012); However, it should also be noted that notional estimates are subject to certain limitations. *See also* ISDA, *OTC Derivatives Market Analysis, Year-End 2011* (June 2012), available online at: http://www2.isda.org/functional-areas/research/studies/ (last accessed: 1 December 2012).

[4] For the purposes of this paper, 'interpretative interference' in the context of transnational private regulation (TPR) is considered to arise where private standard-setters (in this case ISDA) are faced with 'final interpretations of their standards by national courts or other bodies which run counter to their own interpretations, and which could have significant consequences for market practice, but which they do not necessarily have any opportunity to influence'; this is as elaborated in Julia Black & David Rouch, *The Development of the Global Markets as Rule-Makers: Engagement and Legitimacy*, L. & FINAN'L MKTS. REV. 218, 225 (2008).

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will be briefly touched upon in the subsequent sections, along with a primer on OTC derivative instruments and markets more broadly.

B. Overview of Derivatives, Markets and Players

This section will aim to offer a general overview of derivative instruments, market structures and key participants.

I. What are Derivatives?

Derivatives are financial instruments, the value of which are contingent upon the price movements of a broad range of 'underlying' indexes or instruments, for example securities, commodities, currencies, interest rates and third party creditworthiness. Derivatives have been described as fundamentally 'nothing more than probabilistic bets on future events'.[5] They have also been characterized as 'aleatory contracts'; in other words, 'the payoffs to and from each counterparty depend on the outcome of one or more extrinsic, future, uncertain events or metrics...one counterparty expects such outcome to be opposite to that expected by the other counterparty'.[6]

A derivative position enables market participants to gain or lose an amount of money in excess of the 'margin' (collateral) which may have been used to secure the contract. This is known as trading on 'leverage', or 'gearing'.[7] In general, derivatives contracts are used by market participants to engage in hedging,[8] speculation[9] and/or regulatory arbitrage.[10]

[5] Lynn Stout, *Derivatives and the Legal Origin of the 2008 Credit Crisis*, 1 HARV. BUSI. L. REV. 301, 304 (2011).

[6] Timothy Lynch, *Derivatives: A Twenty First Century Understanding* (Indiana University School of Law – Bloomington Legal Studies Research Paper Series, Research Paper No. 187, March 2011), available online at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1785634 (last accessed: 1 December 2012).

[7] Eric Gerding, *Credit Derivatives, Leverage and Financial Regulation's Missing Macroeconomic Dimension*, 8 BERK. BUS. L. J. 101, 113-115 (2011).

[8] A counterparty is exposed to a particular risk and seeks to shift that risk to another party better placed or willing to bear it. *See* Kimberly Krawiec, *Derivatives, Corporate Hedging and Shareholder Wealth: Motigliani-Miller Forty Years Later,* UNIVERSITY OF ILLINOIS LAW REVIEW 1039 (1998); Henry T.C. Hu, *Hedging Expectations: "Derivative Reality" and the Law and Finance of the Corporate Objective*, 21 J. OF COP'N L. 3 (1995).

[9] A counterparty is willing to assume risk and/or seeks to capitalize on superior information regarding price movements without necessarily having direct exposure to the 'underlying'. *See e.g.*, Albert Kyle, *Informed Speculation with Imperfect Competition*, 56 REV. OF ECON. STUD. 317 (1989).

[10] The exploitation of a 'gap between the economic substance of a transaction and its legal or regulatory treatment, taking advantage of the legal system's intrinsically limited ability to attach formal labels that track the economics of transactions with sufficient precision', Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 229 (2011); Frank Partnoy, *Financial Derivatives and the Costs of Regulatory Arbitrage*, 22 J. OF COP'N L. 211 (1997).

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Derivatives contracts may either be 'physically settled' or 'cash settled'. The most common derivatives are options, forwards and swaps; though it should be noted that an array of hybrid and exotic derivatives exist.

II. Some Basic Examples

In an 'option' transaction,[11] the option writer receives a premium for granting the option holder the *right, but not the obligation* to buy a quantity of a particular underlying instrument at a specified price termed the 'strike price' on a specified future date termed the 'strike date'. The underlying instrument could be a security, currency or commodity, for instance. If the prevailing market price, or the 'spot price', is less than the 'strike price', the option holder is considered to be *in the money* because calling in the option would be profitable for the option holder.[12]

'Forwards' represent *both the right and the obligation* either to physically deliver the 'underlying' security, commodity or currency in return for pre-agreed payment or, alternatively, to exchange a 'difference payment' at a specified date in the future.[13] For example, a forward foreign exchange (FX) contract may stipulate that two banks will exchange a given amount of a particular currency for a given amount of different currency at a settlement rate on a set date in the future.[14]

'Swaps' typically involve one or more cash flow exchanges, ultimately dependent upon the performance of some other financial instrument or entity. Perhaps the most notable example of a swap is the credit default swap (CDS). In a CDS a 'protection buyer' makes periodic payments to a 'protection seller' who agrees to compensate the protection buyer in the event that some stipulated 'credit event' occurs with respect to a third party reference entity or instrument not party to the CDS contract.[15] For example, a CDS contract referencing particular sovereign bonds could be triggered by a failure of that sovereign to pay out on those bonds at the time and terms stipulated within the bond contracts.[16]

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[11] For further discussion *see e.g.*, FRANK PARTNOY, INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS 11-12 (2009).

[12] Norman Feder, *Deconstructing Over-the-Counter Derivatives*, 3 COL. BUS. L. REV. 677, 692 (2002).

[13] Feder, *supra* note 12, at 700.

[14] *Id.*

[15] Houman Shadab, *Guilty By Association? Regulating Credit Default Swaps*, 4 ENTR'L BUS. L. J. 407, 431-432 (2010).

[16] For further discussion of CDS, including sovereign CDS in the context of the Eurozone sovereign debt crisis, *see e.g.*, Anna Gelpern & Mitu Gulati, *CDS Zombies,* 13 EUR. BUS. ORG'N L. REV. 347 (2012).

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III. Historical Context

Despite misconceptions, the concept of a derivative instrument was not dreamt up in recent decades. In fact, certain derivatives were possibly in use as early as 2000 B.C.[17] But it is the case that certain types of derivatives, as well as the potential ways in which they can be structured and deployed, have materialized more recently; particularly since the 1980s. As such, the exponential growth in trading of these instruments in recent years has now placed derivatives at the core of global financial markets.[18]

IV. Market Structures

Derivatives are traded within two separate, though increasingly related, markets; termed the 'exchange-traded' and 'OTC' markets. The OTC markets are the primary focus of this paper, although it is necessary to highlight some key features of the parallel exchange-traded market in the interests of context.

Exchanges are central venues or platforms on which derivative instruments are transacted and are often self-regulatory organizations (SROs),[19] answerable to public regulatory authorities. Derivatives traded through exchanges tend to be more widely available and are typically simpler, standardized products. Moreover, central clearing counterparties (CCPs)[20] have traditionally been used in the exchange-traded derivatives markets.[21] CCPs are entities which stand between a buyer and seller, aiming to ensure smooth settlement of derivative transactions and related processes. Hence, one of the key public policy attractions of CCPs is their propensity, theoretically at least, to minimize systemic risk in derivatives markets. Systemic risk has been defined as:

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[17] *See e.g.,* LAURENT JACQUES*,* GLOBAL DERIVATIVE DEBACLES: FROM THEORY TO MALPRACTICE (2010); DON CHANCE, ESSAYS IN DERIVATIVES 16-17 (1998).

[18] *See e.g.*, Dick Bryan and Michael Rafferty, *Financial Derivatives: The New Gold?* 10 COMPETITION & CHANGE 265 (2006).

[19] *See e.g.*, Paul Mahoney, *The Exchange as Regulator*, 83 VIR. L. REV. 1453 (1997); Stephen Pirrong, *The Self-Regulation of Commodity Exchanges: The Case of Market Manipulation*, 38 J. OF L. AND ECON. 141 (1995).

[20] On CCPs *see e.g.*, Craig Pirrong, *The Economics of Central Clearing: Theory and Practice* (ISDA Discussion Papers No. 1, May 2011), available online at: http://www2.isda.org/functional-areas/research/discussion-papers/ (last accessed: 1 December 2012); Stephen Ceccheti, Jacob Gyntelberg & Marc Hollanders, *Central Counterparties for Over-the-Counter Derivatives,* BANK FOR INTERNATIONAL SETTLEMENTS QTL'Y REV. 45, 47 (September 2009); *See also* Franklin Edwards, *The Clearing Association in Futures Markets: Guarantor and Regulator*, 3 J. OF FUT'S MKTS 369 (1983).

[21] Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation,* 55 MRLY'D L. REV. 1, 16-21 (1996).

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> [A] risk of disruption to financial services that is (i) caused by an impairment of all or parts of the financial system and (ii) has the potential to have serious negative consequences for the real economy. Fundamental to the definition is the notion of negative externalities from a disruption or failure in a financial institution, market or instrument. All types of financial intermediaries, markets and infrastructure can potentially be systemically important to some degree.[22]

Meanwhile, OTC derivatives have historically been largely traded bilaterally in less regulated markets[23] and tend to be more 'bespoke' instruments than those traded through exchanges. Moreover, the OTC markets are larger than the exchange-traded markets.[24] OTC derivatives, when deployed appropriately, are capable of offering highly innovative and socially useful risk management strategies.[25] However, many OTC derivatives are also comparatively more opaque[26] and risky than exchange-traded instruments, especially certain OTC derivatives contracts driven by pure speculation.[27]

Counterparty risk is a pertinent issue in OTC derivatives contracts.[28] Counterparty risk arises where one of the parties to the OTC contract fails to discharge their obligations. This can occur, for instance, as a result of the insolvency of a counterparty. Counterparty risk is an acute concern for market participants and policy makers because of its propensity to generate systemic risk. Legal risk is also problematic for OTC derivatives trading and can be related to counterparty risk. The novelty of some types of OTC contracts renders them

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[22] Financial Stability Board, International Monetary Fund and Bank for International Settlements*, Report to the G20 Finance Ministers and Governors: Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations* (7 November 2009), available online at: http://www.financialstabilityboard.org/publications/r_091107c.pdf (last accessed: 1 December 2012).

[23] *See e.g.*, Michael Greenberger, *Overwhelming a Financial Regulatory Black Hole with Legislative Sunlight: Dodd-Frank's Attack on Systemic Economic Destabilization Caused by an Unregulated Multi-Trillion Dollar Derivatives Market*, 6 J. OF BUS. AND TECH. L. 127 (2011).

[24] *See* Bank for International Settlements, *Statistics on Exchange Traded Derivatives* (September 2012), available online at: http://www.bis.org/statistics/extderiv.htm (last accessed: 1 December 2012); Bank for International Settlements, *Semiannual OTC Derivatives Statistics at End-June 2012* (November 2012), available online at: http://www.bis.org/statistics/derstats.htm (last accessed: 1 December 2012).

[25] *See e.g.*, René Stulz, *Should We Fear Derivatives?*, 18 J. OF ECON. PERSP. 173, 182 (2004).

[26] *See e.g.*, Henry Hu, *Too Complex to Depict? Innovation, "Pure Information", and the SEC Disclosure Paradigm*, 90 TEX. L. REV. 1601 (2012); Robert Bartlett III, *Inefficiencies in the Information Thicket: A Case Study of Derivatives Disclosures During the Financial Crisis* 36 J. OF CORP'N L. 1 (2010).

[27] *See e.g.*, Timothy Lynch, *Gambling By Another Name? The Challenge of Purely Speculative Derivatives* (Indiana University Maurer School of Law-Bloomington Legal Research Paper Series No. 188, March 2011), available online at: http://ssrn.com/abstract=1788219 (last accessed: 1 December 2012).

[28] For an overview of key risks in derivatives transactions *see e.g.*, Kimberly Krawiec, *More Than Just New "Financial Bingo": A Risk-Based Approach to Understanding Derivatives*, 23 J. OF CORP'N L. 1, 17-50 (1997).

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susceptible to voidance notwithstanding the wider public regulatory environment. For example, individual contracts may be found by a court to be in contravention of public gambling, insurance or other legislation or to have failed under the laws of contract.[29] Hence, legal risk can prompt counterparty risk and, potentially, systemic risk.

V. OTC Derivatives Players

The OTC derivatives markets are composed of 'dealers' and 'end users'. End users or 'buy side' participants mostly consist of corporations, governmental entities, financial institutions, institutional investors such as hedge funds,[30] and, to a limited extent, high net worth individuals. The 'sell side' in derivatives markets is dominated by dealers.[31] The largest group of dealers is known as the G16.[32] At the time of writing the G16 consisted of:

- Bank of America-Merrill Lynch;
- Barclays;
- BNP Paribas;
- Citigroup;
- Crédit Agricole;
- Credit Suisse;
- Deutsche Bank;
- Goldman Sachs;
- HSBC;
- JPMorgan Chase;
- Morgan Stanley;
- Nomura Group;
- Royal Bank of Scotland;

[29] *See e.g.*, KEITH BLIZZARD, THE LAW OF FINANCIAL DERIVATIVES IN IRELAND (2011).

[30] Hedge funds can be defined as entities which 'capture private pools of capital for collective investment by sophisticated professional —qualified investors, with no or limited regulatory constraints on what the vehicle invests in, allowing short selling in addition to or instead of classic long only investments, using leverage to finance securities positions and magnify funds' return to investors, the use of derivatives to take on or hedge out risks, and generally much more active trading than long – only mutual funds', Wouter Eechoud *et. al.*, *Future Regulation of Hedge Funds: A Systemic Risk Perspective* (2010) 19 FINANCIAL MARKETS, INSTITUTIONS AND INSTRUMENTS 269, 274 (2010).

[31] David Mengle, *Concentration of OTC Derivatives Among Major Dealers* (ISDA: Research Notes No. 4, 2010), available online at: http://www2.isda.org/search?keyword=concentration (last accessed: 1 December 2012).

[32] Matt Cameron, 'G14 Dealer Group Adds Two Members', *Risk.net* (1 December 2011), available online at: http://www.risk.net/risk-magazine/news/2127940/g14-dealer-adds (last accessed: 1 December 2012).

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- Société Générale;
- Union Bank of Switzerland (UBS);
- Wells Fargo.

The dealers 'make the market' by developing products and acting as intermediaries in trades. Dealers themselves also trade OTC derivatives for the benefit of their own accounts, known as proprietary trading.[33] It has been found that 'over 80% of derivative instruments are traded among financial institutions, thus being a predominantly interbank business'.[34]

C. Historic Public Regulation of OTC Derivatives Markets and the GFC

Up until the latter part of the twentieth century, OTC derivatives trading in the predominant markets[35] of the United States (US) and the United Kingdom (UK) ran the risk of falling foul of legislation prohibiting 'off-exchange' trading and/or wagering and/or insurance regulations.[36] However the early 1980s heralded the development of new types of OTC contracts known as 'swaps'[37] which did not easily fit the definitions of listed derivative products under existing public regulatory provisions. This generated considerable uncertainty amongst market participants and prompted intense lobbying. Against the backdrop of a politico-economic intellectual climate which was espousing the infallibility of the efficient markets hypothesis[38] and light public regulation, the UK responded as part of broader reforms in its financial services industry, referred to as 'Big Bang'.

[33] For discussion *see e.g.*, Darrell Duffie, *Market Making under the Proposed Volcker Rule* (Rock Centre for Corporate Governance at Stanford University Working Paper No. 106, 16 January 2012), available online at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1990472 (last accessed: 1 December 2012).

[34] High-Level Expert Group on Reforming the Structure of the EU Banking Sector, *Final Report* 42 (2 October 2012), available online at: http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf (last accessed: 1 December 2012).

[35] For recent geographical breakdowns on market size *see e.g.*, TheCityUK, *Derivatives 2012*, available online at: http://www.thecityuk.com/research/our-work/reports-list/derivatives-2012/ (last accessed: 1 December 2012).

[36] *See e.g.*, Brendan Sapien, *Financial Weapons of Mass Destruction: From Bucket Shops to Credit Default Swaps*, 19 SOUTHERN CAL. INTDSCP'RY L. J. 411 (2010); Lynn Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives,* 48 DUKE L. J. 701 (1999); Patrick Raines & Charles Leathers, *Financial Derivative Instruments and Social Ethics*, 13 J. OF BUS. ETHICS 197 (1994); Thomas Hazen, *Rational Investments, Speculation, or Gambling? – Derivative Securities and Financial Futures and their Effect on the Underlying Capital Markets*, 86 NORTHW'N UNIV. L. REV. 987 (1992).

[37] *See e.g.*, Raphael Hodgson, *The Birth of the Swap*, 65 FIN'L A'LYSTS J. 1 (2009).

[38] For discussion and overview of the Efficient Capital Markets Hypothesis (EMH) *see e.g.*, Eugene Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. OF FIN. 383 (1970).

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The UK *Financial Services Act 1986*[39] and its consequent public regulatory regime operated in practice to absolve OTC derivative trading between 'sophisticated' market participants from direct public regulatory interference. Importantly, it offered OTC trading an enforceability guarantee in the UK.[40] The *caveat emptor* philosophy with respect to OTC derivatives traded between 'sophisticated' market participants was later copper-fastened by the UK *Financial Services and Markets Act 2000* (FSMA).[41] Notwithstanding a respite from analogies with wagering in the event of a dispute in the courts, the UK Financial Services Authority (FSA) was theoretically capable of intervening in the OTC derivatives markets under the UK legislative scheme. However, although the FSA retained wider competencies than those eventually enjoyed by its US counterpart agencies, FSA policy in practice has been described as 'non-interventionist'.[42]

The US response to the development of new OTC products in the 1980s was complicated by politically charged jurisdictional tensions between the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). CFTC and SEC 'turf wars' over certain derivative products can be traced to the creation of the CFTC in the 1970s.[43] The growth of the swaps market in the 1980s only served to inflame inter-agency wrangling. Regulatory exemptions for swaps products were incrementally granted by the CFTC and SEC throughout the 1990s, resulting in a patchwork public regulatory scheme which generated uncertainty amongst market participants. This uncertainty was exacerbated by CFTC and SEC findings in a number of swaps-related mis-selling actions in the mid-1990s.[44]

In the same period, OTC derivatives trading was 'blowing up' a number of economically important entities; both in the US and further afield.[45] Entities which were afflicted by major OTC derivatives trading losses during this time ranged from public municipalities, such as Orange County,[46] international corporations[47] and the Central Bank of Malaysia for

[39] c. 60.

[40] Section 63 of the *Financial Services Act 1986* (UK).

[41] c. 8, section 412.

[42] For discussion *see e.g.*, Daniel Awrey, *The FSA, Integrated Regulation and the Curious Case of OTC Derivatives*, 13 UNIVERSITY OF PENN. J. OF BUS. L. 1, 46 (2010).

[43] Under the Commodity Futures Trading Commission Act 1974, Pub. L. No. 93-463, 88 Stat. 1389 (1974) (CFTA)(US).

[44] *See e.g.*, Wilma Gibson, *Are Swap Agreements Securities or Futures? The Inadequacies of Applying the Traditional Regulatory Approach to OTC Derivatives Transactions*, 24 J. OF CORP'N L. 379 (1999).

[45] Brandon Becker & Jennifer Yoon, *Derivative Financial Losses*, 21 J. OF CORP'N L. 215 (1995).

[46] PHILIPPE JORION, BIG BETS GONE BAD: DERIVATIVES AND BANKRUPTCY IN ORANGE COUNTY (1995).

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instance. Following these events, the CFTC indicated that it was intent on re-examining public regulation in the OTC derivatives markets,[48] coming close to instituting deeper direct public regulation in the swaps market in the late 1990s.

The prospect of CFTC action provoked a backlash from both industry and public stakeholders,[49] including the US Secretary of the Treasury and the Chairmen of the SEC and the US Federal Reserve.[50] Industry and public stakeholders accused the CFTC of overreacting and overstepping its jurisdiction; claiming that the swaps market was capable of efficiently self regulating. Instead, key stakeholders deemed that what was actually needed was 'legal certainty' for OTC derivatives transactions.[51] Spurred by intense lobbying, US legislators thus enacted the sweeping *Commodity Futures Modernization Act 2000* (CFMA).[52] In addition to providing OTC derivatives trading an enforceability guarantee, CFMA essentially prohibited direct intervention by the federal regulatory agencies in OTC derivatives trading between sophisticated market participants, aside from issues such as fraud and market manipulation.

CFMA 2000 in the US and FSMA 2000 in the UK were the primary applicable public regulatory frameworks in those markets at the onset of the GFC; though it should also be noted that other legislative and regulatory provisions nevertheless exerted at least an indirect bearing on certain aspects OTC derivatives trading in the wake of CFMA and FSMA 2000.[53]

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[47] Jongho Kim, *Can Risks be Reduced in the Derivatives Market? Lessons from the Deal Structure Analysis of Modern Financial Engineering Debacles*, 6 DEPAUL BUS. AND COMM. L. J. 29 (2007).

[48] CFTC, *Over-the-Counter Derivatives Concept Release* (7 May 1998), available online at: http://www.cftc.gov/opa/press98/opamntn.htm (last accessed: 1 December 2012).

[49] *See e.g.*, Lawrence Summers, *Testimony Before the US Senate Committee on Agriculture, Nutrition and Forestry on the CFTC Concept Release* (30 July 1998), available online at: http://www.treasury.gov/press-center/press-releases/Pages/rr2616.aspx (last accessed: 1 December 2012).

[50] US Department of the Treasury, *Joint Statement by Treasury Secretary Robert E. Rubin, Federal Reserve Board Chairman Alan Greenspan and Securities and Exchange Commission Chairman Arthur Levitt* (7 May 1998), available online at: http://www.treasury.gov/press-center/press-releases/Pages/rr2426.aspx (last accessed: 1 December 2012).

[51] *See e.g.*, Glenn Morgan, *Reforming OTC Markets: The Politics and Economics of Technical Fixes*, 13 EUR. BUS. ORG'N L. REV. 391 (2012); US President's Working Group on Financial Markets, *Over-the-Counter Derivatives Markets and the Commodity Exchange Act* (November 1999), available online at: [http://www.treasury.gov/resource-center/fin-mkts/documents/otcact.pdf (last accessed: 1 December 2012).

[52] Pub. Law No. 106 – 554, 114 Stat. 2763 (2000) (US).

[53] For instance Directive 2004/39/EC of the European Council and of the Parliament on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC and repealing Council Directive 93/22/EEC [2004] OJ L 145 (MiFID).

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I. The GFC and the Public Regulatory Response

Firstly, it should be pointed out that derivative-related trading losses, crises and scandals are nothing new when considered in historical context. From 'Tulipmania' in the 17th century[54] to the Enron scandal[55] in the early 21st century and many other 'blow ups' in between, derivatives played a role in financial market crises before 2007. OTC derivatives are also lurking in the background of the current Eurozone sovereign debt crisis,[56] which is worrying policy makers, along with other OTC derivative-related headaches.[57] However, it should also be highlighted that OTC derivative-related crises are the exception rather than the norm. On the other hand, where OTC derivative-related meltdowns have occurred throughout history, these crises appear to have become progressively more serious each time for stakeholders beyond the immediate industry. Therefore, the financial crisis materializing in 2007, which clearly had an OTC derivatives component, may have been a new departure in economic history.

While OTC derivatives were indeed inherently connected with the GFC originating in 2007, they did not, in and of themselves, cause the GFC. The GFC owes its origin to a wider conjunction of factors[58] in the international financial system which, once triggered by the collapse of the US mortgage market, merged to generate an unprecedented crisis which continues to reverberate and evolve.[59] What is clear, though, is that the manner and

[54] Peter Garber, *Famous First Bubbles*, 4 J. OF ECON. PERSP'S 35 (1990).

[55] Frank Partnoy, *Enron and Derivatives: Testimony before the United States Senate Committee on Government Affairs* (24 January 2002), available online at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=302332 (last accessed: 1 December 2012).

[56] *See e.g.*, Stephanie Bodoni *et. al.*, 'ECB Wins Ruling to Deny Access to Secret Greek Swap Files', *Bloomberg* (29 November 2012), available online at: http://www.bloomberg.com/news/2012-11-29/ecb-wins-ruling-to-deny-access-to-secret-greek-swap-files.html (last accessed: 1 December 2012).

[57] For instance, the role of OTC derivatives in the interbank rate setting scandals and mis-selling controversies. *See e.g.*, UK Treasury, *The Wheatley Review of LIBOR: Final Report* (September 2012), available online at: http://cdn.hm-treasury.gov.uk/wheatley_review_libor_finalreport_280912.pdf (last accessed: 1 December 2012); UK FSA, *FSA Agrees Settlement with Four Banks Over Interest Rate Hedging Products* (29 June 2012), available online at: http://www.fsa.gov.uk/library/communication/pr/2012/071.shtml (last accessed: 1 December 2012).

[58] *See e.g.*, Donald Langevoort, *Chasing the Greased Pig Down Wall Street: A Gatekeepers Guide to the Psychology, Culture and Ethics of Financial Risk-Taking*, 96 COR. L. REV. 1209 (2011); Erik Gerding, *Code, Crash and Open Source: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis*, 84 WASH. L. REV. 127 (2009); UK FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009) [http://www.fsa.gov.uk/pubs/other/turner_review.pdf]; Raghuram Rajan, *Has Financial Development Made the World Riskier?* (NBER Working Paper, 2005), available online at: http://www.nber.org/papers/w11728.pdf?new_window=1 (last accessed: 1 December 2012).

[59] VIRAL ACHARYA *ET. AL.*, GUARANTEED TO FAIL: FANNIE MAE, FREDDIE MAC AND THE DEBACLE OF MORTGAGE FINANCE (2011); MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010); DAVID FABER, AND THEN THE ROOF CAVED IN: HOW WALL STREET'S GREED AND STUPIDITY BROUGHT CAPITALISM TO ITS KNEES (2009); ANDREW SORKIN, TOO-BIG-TO-FAIL: THE INSIDE

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extent to which OTC derivatives were *used (and misused) and bundled* dangerously fuelled the securitized model of credit intermediation.[60] In sum, the manner and extent of OTC derivatives deployment by human actors[61] played a key role in heightening systemic risk in the lead up to, and during, the GFC. The GFC spurred sovereigns to prop up a number of distressed systemically important institutions, especially in the EU and US.[62] This, in turn, constituted a crucial bridge between the GFC and the Eurozone sovereign debt crisis occurring at the time of writing.[63]

Declarations issued by the G20 nations in the wake of the GFC have thus called for OTC derivative transactions to be shifted, where appropriate, to regulated exchanges/alternative venues and to be channeled through CCPs. 'Non-cleared' OTC derivatives should also be subject to more robust risk management requirements. Moreover, OTC derivatives should also be subject to enhanced public reporting requirements.[64] At the time of writing, the US and EU are at an advanced stage in the implementation of these market infrastructure reforms.[65] However, there are ongoing concerns that inconsistency and divergences between jurisdictions may prompt potentially

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STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM – AND THEMSELVES (2009); Markus Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007-2008*, 23 J. OF ECON. PERSP'S 77 (2009); GILLIAN TETT, FOOL'S GOLD: HOW UNRESTRAINED GREED CORRUPTED A DREAM, SHATTERED GLOBAL MARKETS AND UNLEASHED A CATASTROPHE (2009).

[60] *See e.g.*, Gary Gorton, *Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007* (Yale University and National Bureau of Economic Research Working Paper, May 2009) 8, available online at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1401882 (last accessed: 1 December 2012).

[61] For discussion of some dynamics of human risk taking in derivatives markets *see e.g.*, John Coates and Joe Herbert, *Endogenous Steroids and Financial Risk Taking on a London Trading Floor*, 105 PROCEEDINGS OF THE NATIONAL ACADEMY OF SCIENCES OF THE UNITED STATES OF AMERICA 6167 (2008). *See also*, Andrew Lo and Dmitry Repin, *The Psychophysiology of Real-Time Financial Risk Processing,* 14 J. OF COG. NEUROSC. 323 (2002),

[62] William Sjostrum Jnr., *The AIG Bailout*, 66 W. & L. L. REV. 943 (2009); UK FSA, *The Failure of the Royal Bank of Scotland* (December 2011), available online at: http://www.fsa.gov.uk/static/pubs/other/rbs.pdf (last accessed: 1 December 2012).

[63] *See e.g.*, Ashoka Mody & Damiano Sandri, *The Eurozone Crisis: How Banks and Sovereigns Came to be Joined at the Hip* (International Monetary Fund Working Paper 11/269, 2011), available online at: http://www.imf.org/external/pubs/ft/wp/2011/wp11269.pdf (last accessed: 1 December 2012).

[64] G20, *Leaders' Statement: The Pittsburgh Summit (*24-25 September 2009), available online at: http://www.g20.utoronto.ca/2009/2009communique0925.html (last accessed: 1 December 2012).

[65] Financial Stability Board, *OTC Derivatives Market Reform: Fourth Progress Report on Implementation* (31 October 2012), available online at: http://www.financialstabilityboard.org/publications/r_121031a.pdf (last accessed: 1 December 2012); CFTC and SEC, *Joint Report on International Swap Regulation* (31 January 2012), available online at: http://www.sec.gov/news/studies/2012/sec-cftc-intlswapreg.pdf (last accessed: 1 December 2012).

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damaging regulatory arbitrage.[66] While emerging public regulatory reform can be said to 'interfere' with private regulatory regimes, consideration of this broader dynamic is largely outside the scope of this particular paper.[67]

II. The Significance of the Lehman Bankruptcy

Suffice to say that the bankruptcy of Lehman Brothers[68] in September 2008[69] represented an acute counterparty and legal risk for the OTC derivatives markets, as well as for the international financial system more broadly.[70] Lehman retained operations across jurisdictions which operated in the absence of legally mandated coordination between national public supervisors, insolvency and resolution frameworks.[71] Hence, for the industry, this event raised, *inter alia*, the specter of disruptive 'interpretative interference'[72] by public courts in the private regulatory regime governing trading in the OTC derivatives markets.

In order to illustrate why the Lehman bankruptcy was a crucial watershed moment for the industry in this sense, the evolution of private regulation in these markets and its key objectives in the lead up to the GFC will be surveyed next. As will be demonstrated, the Lehman collapse threatened to undo, on an unprecedented scale, industry attempts over the past two decades to keep OTC derivatives disputes out of the public courts as far possible and narrow the available forums for litigation where it may arise.

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[66] *See e.g.*, Christian Johnson, *Regulatory Arbitrage, Extraterritorial Jurisdiction and Dodd-Frank: The Implications of Global US OTC Derivative Regulation* (University of Utah College of Law Working Paper, 30 October 2012), available online at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2169401 (last accessed: 1 December 2012).

[67] For further discussion on this, *see* Morgan, *supra* note 51.

[68] *In re Lehman Brothers Inc*., US Bankruptcy Court, Southern District of New York, No. 08-13555.

[69] *See e.g.*, Vincent Reinhart, *A Year of Living Dangerously: The Management of the Financial Crisis in 2008*, 25 J. OF ECON. PERSP'S 71 (2011).

[70] For discussion *see e.g*., Satyajit Das, *In the Matter of Lehman Brothers*, 59 WILMOTT 20 (2012).

[71] *See* Adrienne Coleton, *Banking Insolvency Regimes and Cross-Border Banks – Complexities and Conflicts: Is the Current European Insolvency Framework Efficient and Robust Enough to Effectively Resolve Cross-Border Banks, Can There Be a One Size Fits All Solution?*, 27 J. OF INT'L BANK'G L. AND REG. 63 (2012); Barbara Attinger, *Crisis Management and Bank Resolution Quo Vadis, Europe?* (ECB Legal Working Paper Series, December 2011), available online at: http://www.ecb.int/pub/pdf/scplps/ecblwp13.pdf (last accessed: 1 December 2012).

[72] Black and Rouch, *supra* note 4.

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D. Transnational Private Regulation in the OTC Derivatives Markets

Up until the mid-1980s, OTC derivatives transactions were documented differently depending on the particular dealer bank involved in the trade. This documentation rivalry between dealers has been popularized as the 'Battle of the Forms'.[73] With a view to reducing transaction costs, enhancing legal certainty and promoting the development of the market generally, the dealer banks thus resolved to standardize OTC derivative transactions. Following sometimes fraught negotiations, this initiative culminated in agreement on common definitions, known as the 'Swaps Code', in 1985. The Swaps Code was supervised by a newly created trade association, the International Swaps Dealers Association; later renamed the International Swaps and Derivatives Association (ISDA).[74] By 1987, a full-blown standard ('boilerplate') contract had been developed, known as the ISDA Interest Rate and Currency Exchange Agreement. By the early 1990s ISDA had embarked on ambitious revisions and new documentation resulting in the publication of the 1992 ISDA Master Agreement which heralded, *inter alia*, an extension in the range derivative products which could be covered and took into account changes in market practices and laws. The 1992 Master Agreement was in turn revised in the early 2000s.[75]

ISDA was originally set up by and for the derivatives dealers but, as the OTC derivatives market evolved, ISDA's membership and internal governance came to encompass a broader constituency of players. As such, ISDA acted as a crucial conduit for industry lobbying of legislators and public regulators and ISDA's influence in this sphere should not be underestimated. This is perhaps best illustrated by ISDA's central role in successfully agitating for public deregulation of OTC derivatives markets in the late 1990s, especially in the US.[76] It would also be reasonable to suggest that public policy makers found it easy to be positively disposed towards the ISDA TPRER insofar as it appeared to offer a credible mechanism through which the OTC derivatives industry could efficiently self-regulate. ISDA was quite aware of its credibility, undoubtedly enhanced by the sheer economic power of

[73] Sean Flanagan, *The Rise of a Trade Association: Group Interactions within the International Swaps and Derivatives Association*, 6 HARV. NEG. L. REV. 211, 235 (2001); Jeffrey Golden, *Setting Standards in the Evolution of Swap Documentation*, 13 INT'L FIN.'L L. REV. 18 (1994).

[74] For further discussion of ISDA *see e.g.*, HEATHER MCKEEN-EDWARDS AND TONY PORTER, TRANSNATIONAL FINANCIAL ASSOCIATIONS AND THE GOVERNANCE OF GLOBAL FINANCE: ASSEMBLING POWER AND WEALTH (2012, forthcoming); Glenn Morgan, *Power and Legitimacy in Financial Markets: Credit Default Swaps in the Current Crisis*, 8 SOCIO-ECONOMIC REV. 17 (2010).

[75] PAUL HARDING, MASTERING THE ISDA MASTER AGREEMENTS (1992 AND 2002) (2010).

[76] Partnoy, *supra* note 11, at 293, noting that '[a]nyone who imagined that members of Congress, or their staffs, drafted laws regarding derivatives would have been surprised to peek inside the offices of the House Agriculture Committee during the time Congress was considering the CFMA. Instead of seeing members of Congress at work, you would have seen Mark Brickell, the lobbyist from ISDA, writing important pieces of the legislation'.

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its key members, and particularly the crucial 'signaling' role which was played by well developed and widely used ISDA boilerplate contracts.[77] Once ISDA had ensured that public regulation had largely, though not entirely, been seen off by the early 2000s, this ushered in a period of unprecedented growth for the OTC derivatives markets.

Accordingly, as of 2008 ISDA was reported to be the largest global financial trade association.[78] ISDA's membership base[79] encompasses OTC derivatives dealers (primary members),[80] end users such as hedge funds and large corporations (subscriber members)[81] and servicing entities, such as reputable law and accounting firms (associate members).[82] A cadre of primary member derivatives dealer banks (G16), also known as the 'derivatives dealers club',[83] have continued to exert considerable influence within ISDA since its formation. This is exemplified, for example, by a strong dealer presence on the ISDA Board of Directors.[84] In fact, the successful emergence and sustenance of ISDA may have been heavily predicated on the dynamics of this 'producer influence'.[85]

And in the wake of the GFC ISDA has managed not to be excluded from public regulatory reform processes either. In fact, ISDA played a key role soon after the GFC materialized in encouraging industry to 'compress' economically redundant transactions.[86] Moreover,

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[77] On a similar theme in the context of collective action clauses (CACs), *see* Anna Gelpern & Mitu Gulati, *Public Symbol in Private Contract: A Case Study*, 84 WASH. UNIV. L. REV. 1627 (2006); More broadly, *see e.g*., Mark Suchman, *The Contract as Social Artefact*, 37 L. AND SOC. REV. 91 (2003).

[78] Robert Pickel, *Testimony Before the United States Senate Committee on Agriculture, Nutrition and Forestry* (Washington D.C.: 14th October 2008) (on file with author).

[79] ISDA, *Members List* (20 August 2012), available online at: http://www.isda.org/membership/institutionallist.pdf (last accessed: 1 December 2012).

[80] ISDA, *Primary Members List* (20 August 2012), available online at: http://www2.isda.org/about-isda/join-isda/primary-members (last accessed: 1 December 2012).

[81] ISDA, *Subscriber Members List* (20 August 2012), available online at: http://www2.isda.org/about-isda/join-isda/subscriber-members (last accessed: 1 December 2012).

[82] ISDA, *Associate Members List* (20 August 2012), available online at: http://www2.isda.org/about-isda/join-isda/associate-members (last accessed: 1 December 2012).

[83] Robert Litan, *The Derivatives Dealers' Club and Derivatives Markets Reform: A Guide for Policy Makers, Citizens and Other Interested Parties* (Initiative on Business and Public Policy, Brookings 7 April 2010) (on file with author).

[84] ISDA, *Board of Directors*, available online at: http://www2.isda.org/about-isda/board-of-directors/ (last accessed: 1 December 2012).

[85] On producer influence in TPR *see e.g*., Daniel Mügge, *Private-Public Puzzles: Inter-firm Competition and Transnational Private Regulation,* 11 NEW POLT'L ECON. 177 (2006).

[86] On compression *see e.g.*, Nicholas Vause, *Counterparty Risk and Contract Volumes in the Credit Default Swap Market*, BANK FOR INT'L STTL'TS QT'LY REV. 59, 63 (December 2010).

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ISDA is now playing a pivotal role in assisting public regulatory authorities, particularly the OTC Derivatives Supervisors Group,[87] in identifying, for example, OTC derivatives which may be suitable for central clearing and exchange trading.[88]

I. Basics of the ISDA Master Agreement

As indicated, ISDA standard-setting centers on the ISDA Master Agreement, which is supported by other documents. Each of these documents fulfills a particular function in recording the OTC derivatives transaction. Firstly, the Master Agreement itself is a boilerplate[89] contract containing standard legal obligations arising out of the transactional relationship. Provisions include, *inter alia*, general day-to-day obligations owed by each party to the transaction, as well as provisions addressing events of default, termination events, immunity issues, basic representations and so forth.

The Master Agreement is clearly drafted with common law jurisdictions in mind. Guidance accompanying the choice of law provisions strongly recommends that transactions documented under the Master Agreement should be confined to either the English or Southern District of New York (SDNY) courts.[90] The Master Agreement is normally combined with 'confirmation documents' recording the specific economic details of the transaction, thereby affording individual OTC transactions their 'bespoke' flavor.[91] Certain legal terms of the Master Agreement can also be further amended through a Schedule.

Parties will usually secure themselves in bilateral OTC derivatives transaction/s through the pledging of security or collateral. In fact, collateral (particularly in the form of cash)[92] has become an extremely important tool in governing OTC derivatives transactions. Collateral arrangements are typically governed by credit support documents, frequently a version of the ISDA Credit Support Annex (CSA).[93] Where collateral agreements are in place, they will typically shift throughout the period of transactional relationships, contingent upon the

[87] Federal Reserve Bank of New York, *OTC Derivatives Supervisors Group*, available online at: http://www.newyorkfed.org/markets/otc_derivatives_supervisors_group.html (last accessed: 1 December 2012).

[88] *See e.g.*, ISDA, *Supporting G20 Objectives*, available online at: http://www2.isda.org/G20objectives (last accessed: 1 December 2012).

[89] Stephen Choi & Mitu Gulati, *Contract as Statute*, 104 MICH. L. REV. 1129, 1139-1140 (2006).

[90] ISDA Master Agreement 2002 Users Guide (on file with author).

[91] Choi & Gulati, *supra* note 89, at 1140.

[92] ISDA, *ISDA Margin Survey 2012* (1 May 2012), available online at: http://www2.isda.org/functional-areas/research/surveys/margin-surveys/ (last accessed: 1 December 2012).

[93] *See e.g.*, CHRISTIAN JOHNSON, A GUIDE TO USING AND NEGOTIATING OTC DERIVATIVES DOCUMENTATION (2005).

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credit ratings assigned to each party. ISDA periodically also issues industry Protocols which have a 'signup' element. An apt example is the 'Big Bang'[94] and 'Small Bang' Protocols[95] which overhauled private governance of the CDS markets in the wake of the GFC.[96]

II. Supporting the Master: Reducing Ex-Ante Legal Uncertainty

As part of, and beyond, its lobbying activities, ISDA actively seeks to shore up the legal enforceability of its Master Agreements by encouraging ex-ante legal certainty. This is achieved in a couple of interrelated ways. The first element of the strategy involves extensive technical engagement with public legislative and regulatory actors at both the supranational[97] and national levels with the objective of enshrining so-called 'safe harbors' for OTC derivatives contracts and associated collateral from public insolvency and gambling laws.[98] ISDA, as well as other international actors,[99] argue that statutorily guaranteed legal certainty for OTC derivatives in insolvency ('close-out netting'), as well as protection from gambling legislation, is essential for financial stability.[100] Although this contention is contestable,[101] national legislators have generally found ISDA's argumentation persuasive, particularly when it is also framed as a necessary condition for

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[94] ISDA, *Auction Hardwiring*, available online at: http://www.isda.org/companies/auctionhardwiring/auctionhardwiring.html (last accessed: 1 December 2012).

[95] ISDA, *Small Bang Protocol*, available online at: http://www.isda.org/smallbang/ (last accessed: 1 December 2012).

[96] *See e.g*. ISDA, *The ISDA Credit Derivatives Determinations Committees* (June 2012), available online at: http://dc.isda.org/ (last accessed: 1 December 2012).

[97] *See e.g.*, ISDA, *Proposal to UNIDROIT for a Netting Convention* (London: 15th March 2008), available online at: https://www.isdadocs.org/speeches/pdf/Unidroit-NetConv-Mar.pdf (last accessed: 1 December 2012).

[98] *See e.g*., John Biggins & Colin Scott, *Public-Private Relations in a Transnational Private Regulatory Regime: ISDA, the State and OTC Derivatives Market Reform*, 13 EUR. BUS. ORG'N L. REV. 309 (2012).

[99] *See e.g*., Basel Committee on Banking Supervision, *Report and Recommendations of the Cross-Border Bank Resolution Group* (March 2010), available online at: http://www.bis.org/publ/bcbs169.pdf (last accessed: 1 December 2012); United Nations Commission on International Trade Law (UNICTRAL), *Legislative Guide on Insolvency Law* (New York, 2005), available online at: http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf (last accessed: 1 December 2012).

[100] For discussion of this interaction between ISDA and nation states, *see* Biggins & Scott, *supra* note 98.

[101] *See e.g*., Darrell Duffie & David Skeel Jnr., *A Dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements* (Stanford University Working Paper No. 108, 1 March 2012), available online at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1982095 (last accessed: 1 December 2012); Mark Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator,* 63 STAN. L. REV. 539 (2011); Stephen Lubben, *Repeal the Safe Harbours*, 18 AM. BNKR'Y INST. L. REV. 319 (2010).

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the attraction of financial services business.[102] As of July 2011, at least 43 countries had adopted or were considering netting legislation.[103]

Secondly, ISDA supplements this activity by commissioning legal opinions from reputable law firms on the enforceability of safe harbors and collateral rights in individual jurisdictions. These opinions carry particular importance for trading in jurisdictions where OTC friendly legislation does not yet exist. These opinions are made available to ISDA members and provide a mechanism for bolstering confidence that transactions may not be liable to disruption by unforeseen interpretations, particularly of public legislative provisions. As of August 2012, ISDA had commissioned 57 netting opinions and 48 collateral opinions.[104]

III. Collateral Damage? The Role of Collateral in the ISDA Regulatory Regime

In an illuminating ethnographic study of the OTC derivatives markets, Annelise Riles focused on the neglected consideration of the private regulatory role of collateral or security. Recall that collateral is deployed by market participants (usually in the form of cash) in addition to principal contractual obligations in order to secure OTC transactions.

Riles argues that, although it is an 'artifact' of national law, collateral is simultaneously capable of being deployed to run 'an end-game around certain aspects of national law'.[105] During field studies at a Japanese bank, Riles was surprised to learn that, although the ISDA Master Agreement collateral support document sets out formal procedures for public court enforcement in the event of a dispute between counterparties, this is not preferred. Instead, it was found that back office 'documentation people' and derivatives traders preferred to liaise informally and reach a mutually acceptable settlement based on collateral payments.[106]

Riles brands collateral a 'self help mechanism' and a 'private constitution' for the OTC trading relationship.[107] However, Riles suggests that these dynamics should not necessarily

[102] Biggins & Scott, *supra* note 98.

[103] ISDA, *Opinions*, available online at: http://www2.isda.org/functional-areas/legal-and-documentation/opinions (last accessed: 1 December 2012).

[104] *Id*.

[105] RILES (2011), *supra* note 2, at 41.

[106] *Id*. at 56.

[107] Annelise Riles, *The Anti-Network: Private Global Governance, Legal Knowledge, and the Legitimacy of the State*, 56 AMER. J. OF COMP. L. 605, 612 (2008).

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be read as a replication of the primary importance of trust and other extra-legal dispute resolution dynamics detected in other industries.[108] Neither should it be read as indicating the existence of a formal type of alternative dispute resolution mechanism, such as international commercial arbitration. Instead, Riles posits that collateral is a form of law which 'aims to be the *obviation* of dispute resolution, as well as its apotheosis' in the OTC derivative markets. Therefore, collateral's '*modus operandi* is not at all alternative and analogous to standard law, with its disputes resolved according to norms enshrined in legal processes'.[109]

Riles highlights the centrality of collateral-based resolution mechanisms both during, and in the wake of, the GFC; pointing to demands by Goldman Sachs for its derivatives counterparty, American International Group (AIG), to post further collateral as AIG spiraled towards collapse and eventual nationalization. This drama provoked intense press coverage but Riles makes the interesting point that at no stage was there much debate as to whether AIG was actually legally obligated to respond to Goldman's collateral calls. 'This was taken as simply a background rule of the game'.[110] Therefore, it could be ventured that the centrality of collateral mechanisms in the OTC markets may be a prime example of a norm which has 'crystallized'[111] over time at the expense of other norms or mechanisms which are foreseen by the regulatory regime but not regularly invoked.

However, as the GFC has demonstrated, there are limitations in the capacity of collateral, in and of itself, to always perform a dispute resolution function, possibly at times when it is most crucial. In other words, and this distinction is also recognized by Riles,[112] practice does not always conform to the 'ambition' of collateral. I term this 'collateral damage'. An apt example of this is a formal court action instigated by Lehman Brothers alleging that one of its counterparties, JPMorgan Chase, illegally sucked US$8.6 billion in collateral out of Lehman in the days leading up to its bankruptcy.[113] Hence, the potential for collateral disputes to become increasingly frayed in the wake of the GFC has seemingly been

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[108] Such as Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry,* 21 J. OF LEG. STUD. 115 (1992); Robert. Ellickson, *Of Coase and Cattle: Dispute Resolution Among Neighbours in Shasta County*, 38 STAN. L. REV. 624 (1986).

[109] RILES (2011), *supra* note 2, at 56-57.

[110] *Id.* at 4.

[111] Donal Casey & Colin Scott, *The Crystallization of Regulatory Norms*, 38 J. OF LAW & SOC. 76, 81 (2011).

[112] RILES (2011), *supra* note 2, at 57.

[113] *Lehman Brothers Holdings Inc. and Official Committee of Unsecured Creditors of Lehman Brothers Holdings Inc., et al.* v *JPMorgan Chase Bank NA*, 10-ap-03266, US Bankruptcy Court (SDNY, Manhattan).

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recognized by ISDA; perhaps illustrated by the publication of an ISDA Collateral Dispute Resolution Procedure in 2009.[114]

Accordingly, given the possibility for the traditional collateral-based dispute mechanism to be less reliable in the wake of the GFC, the next section considers the potential significance of choice-of-law provisions in the enforcement of the ISDA Master Agreement.

IV. Clear Choices and 'Targeted Touchdown': The Role of Choice of Law in the ISDA Regulatory Regime

It has been observed that the ISDA Master Agreement was drafted by 'American and British lawyers' and is 'laden with assumptions about market practices in the American and British markets'.[115] Perhaps as an implicit recognition of this and a desire to confine formal OTC derivatives litigation to the public courts of jurisdictions which are perceived to be 'derivatives friendly', choice of law provisions in the ISDA Master Agreement counsel in favor of choosing English or New York law to govern the contract.

Choice of law provisions are typically contained in both the boilerplate part of the Master Agreement and in the supporting documents. For example, Section 13 of the 2002 ISDA Master Agreement only references enforcement arrangements in the case of referral to England or New York, although it does recognize the possibility that referral to another jurisdiction could occur (more about that in a moment). Part 4(h) of the Schedule to the 2002 ISDA Master Agreement, which permits the counterparties to tailor legal aspects of the boilerplate contract, also seems to implicitly assume that England or New York will govern the transaction. Tellingly, the ISDA User's Guide for the 2002 Master Agreement contains the following guidance:

> Parties that wish to elect a governing law for the 2002 Agreement other than English law or the laws of the State of New York should carefully consider such an election with their legal advisers.[116]

This is an opportune juncture to place these features of the ISDA regulatory regime into the theoretical framework offered by Robert Wai. Wai has critiqued the 'global law

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[114] ISDA, available online at: 2009 ISDA Collateral Dispute Resolution Procedure (September 30, 2009) available online at: http://www.isda.org/c_and_a/pdf/ISDA-Collateral-Committee-Dispute-Resolution-Proposal-Briefing.pdf (last accessed: 1 December 2012).

[115] RILES (2011), *supra* note 2, at 62.

[116] ISDA, *Users Guide to the 2002 Master Agreement* (on file with author).

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without a state' or *new lex mercatoria* literature,[117] championed for example by Gunther Teubner.[118] Teubner and others have emphasized the importance of the 'liftoff' of transnational business transactions and contracts from both national and international legal systems towards 'autopoietic' private transnational norm setting and dispute resolution. The growing importance of international commercial arbitration is frequently highlighted in this context; especially its reputed capacity to operate entirely independently of national and international public regulatory orders.

Wai argues for a more holistic analytical framework than the one championed by Teubner and others. Wai does not reject the *new lex mercatoria* literature out of hand. Rather, Wai counsels against the 'singularity', termed *lex mercatoria propria*, in some of that literature.[119] Wai contends that private law, both at the national and international level, remains relevant in considering overall frameworks of transnational business relations and dispute resolution more generally. Wai suggests that it is not entirely clear that 'liftoff' can be fully achieved in transnational commercial relations. Instead, Wai contends that '[n]ational courts are still one of the locations at which international transactions and the international economy must "touch down" to achieve certain benefits'.[120] Importantly, Wai observes that international commercial arbitration may itself only be sustainable insofar as it is backstopped by national legislative and judicial processes.

Therefore, drawing on critical legal theory, Wai suggests that 'in a plural transnational society, normative systems operate in the shadow of each other...the normative code of any particular system is rife with contradictions, gaps and ambiguities'.[121] Wai proffers that '[n]o single rationality or discourse dominates private international law and private law; rather, there is an array of different goals and priorities that generate a force field of policy concerns'.[122] This is also what Colin Scott might term a 'fragmented regulatory space'.[123]

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[117] As have others. *See e.g.*, Ralf Michaels, *The Re*-state-*ment of Non-State Law: The State, Choice of Law and the Challenge of Global Legal Pluralism*, 51 WAYNE L. REV. 1209 (2005).

[118] *See e.g.,* Gunther Teubner, *"Global Bukowina": Legal Pluralism in the World Society*, *in* GLOBAL LAW WITHOUT A STATE (Gunther Teubner ed., 1997).

[119] Robert Wai, *The Interlegality of Transnational Private Law*, 71 LAW AND CONTEMPORARY PROBLEMS 107, 114 (2008) [hereinafter "Wai (2008)"].

[120] Robert Wai, *Transnational Liftoff and Juridical Touchdown: The Regulatory Function of Private International Law in an Era of Globalization*, 40 COL. J. OF TRANSN'L L. 209, 265 (2002).

[121] Wai (2008), *supra* note 119, at 116.

[122] Robert Wai, *Transnational Private Law and Private Ordering in a Contested Global Society*, 46 HARV. INT'L L. J. 471, 483 (2005).

[123] Colin Scott, *Analysing Regulatory Space: Fragmented Resources and Institutional Design*, PUBLIC LAW 283 (2001).

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The main features of the ISDA regulatory regime appear to fit more readily into Wai's framework than into Teubner's. The ISDA regulatory regime is not 'anational'; it appears to be 'beyond but not without the state'.[124]

While Riles identified the role of informal dispute resolution mechanisms through collateral, although itself related to hard law processes, it has demonstrably not been possible for collateral to entirely supplant other formal dispute resolution mechanisms. Importantly for the purposes of this paper, Wai identifies forum selection and choice-of-law clauses as performing a 'clear governance role'[125] in specifying venues for dispute resolution and the applicable state law where litigation arises. Drawing inspiration from Wai, insofar as ISDA seeks to confine litigation under the Master Agreement to England and New York, I term the ISDA choice-of-law mechanism 'targeted touchdown'. Targeted touchdown aims to minimize public regulatory interference in the ISDA TPRER but its limitations in this respect will be illustrated.

V. Clipping the Wings of Choice-of-Law

It is a truism that although counterparties to an ISDA Master Agreement may seek to confine formal litigation to England or New York, it is not always possible to do this. Conflict-of-laws doctrine may dictate that, for example in the insolvency of a cross-border derivatives market participant, national courts not foreseen in the ISDA Master Agreement may become forcibly involved in the transaction nonetheless. For instance, the law of the jurisdiction (*lex concursus*) where insolvency proceedings have been instigated may in practice serve to override all or part of the operation of the choice-of-law (*lex contractus*) clause in the ISDA Master Agreement. This is a major worry for derivatives market participants which is why ISDA is active in ensuring that as many jurisdictions as possible harmonize the substance of their insolvency legislation and ensure they are as 'OTC derivatives friendly' as possible.

Because *lex concursus* interference is well recognized in the financial markets and dealt with elsewhere it is not considered further here.[126] However, the next section suggests that even though ISDA and the industry seek targeted touchdown of litigation in England and New York, the English and New York courts have nonetheless occasionally interpreted

[124] *See e.g.*, Ralf Michaels, *The True Lex Mercatoria: Law Beyond the State*, 14 IND'A. J. OF GLOB. LEG. STUD. 447 (2007).

[125] Wai (2008), *supra* note 119, at 122-123.

[126] For further discussion *see e.g.*, Philipp Paech, *The Need for an International Instrument on the Enforceability of Close-Out Netting in General and in the Context of Bank Resolution* (Preliminary Draft Report, UNIDRIOT Study Group on Principles and Rules on the Netting of Financial Instruments, March 2011), available online at: http://www.unidroit.org/english/documents/2011/study78c/s-78c-02-e.pdf (last accessed: 1 December 2012).

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both public laws and the ISDA Master Agreement in ways which have not conformed to the interests of dominant members of the ISDA regulatory regime.[127] Following consideration of selected cases leading up to and including the Lehman bankruptcy, there will be discussion of potential implications for the longer term effectiveness and legitimacy of the ISDA regulatory regime, as well as emerging industry responses to this in the wake of the GFC.

VI. From Hammersmith to Eternity and Beyond: A Tale of Three (and Potentially Four) Limitations of Targeted Touchdown for the OTC Derivatives Industry

Mention of the so-called 'UK Local Authority Swaps Cases' is still enough to make OTC derivatives market participants shudder, even 20 years later. The seminal case in this category is *Hazell* v *Hammersmith and Fulham London Borough Council & Others*.[128] *Hammersmith* (the Borough Council) had entered into a number of interest rate swap transactions with OTC derivatives dealer banks between 1987 and 1989. The trades led to the exposure of the Borough Council to potentially significant losses, prompting the UK Audit Commission for Local Authorities to instigate proceedings seeking to have the swaps transactions declared *ultra vires* the Borough Council.

This case hinged upon the interpretation of a section of UK local government legislation[129] and reached the UK House of Lords, where it was declared that the Borough Council had acted *ultra vires*. In spite of protestations by the dealer banks that they could be exposed to potentially devastating losses,[130] all of the swap agreements were declared void and unenforceable, regardless of whether they were motivated by a desire to hedge or speculate.[131] This reversed the finding of the Court of Appeal which had previously held that only the speculative transactions were void and that the swaps hedging contracts were enforceable.

[127] On a similar theme, *see e.g.*, Jonathan Ross, *The Case for P.R.I.M.E. Finance: P.R.I.M.E. Finance Cases*, 7 CAP. MKT'S L. J. 221 (2012).

[128] *Hazell* v *Hammersmith and Fulham London Borough Council & Ors* [1992] 2 AC 1. For discussion *see e.g.*, Andrew Tickle, *Creative Finance and the Local State: The Hammersmith and Fulham Swaps Affair*, 17 POL. GEOG. 865 (1998).

[129] In particular section 111(1) of the UK Local Government Act 1972 which stipulated that 'a local authority shall have power to do anything (whether or not involving the expenditure, borrowing or lending of money or the acquisition or disposal of any property or rights) which is calculated to facilitate, or is conducive or incidental to, the discharge of any of their functions'.

[130] *Hazell* v *Hammersmith and Fulham London Borough Council & Ors* [1992] 2 AC 1, 36.

[131] Ibid., 37, *per* Lord Templeman.

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This ruling was the opening salvo for further local authority swaps disputes, as contracts which were affected by the decision in *Hammersmith* were litigated through the courts.[132] If *Hammersmith* had been left on the hook for the swaps transactions by the House of Lords, it is clear that the Borough Council ratepayers would likely have had to absorb losses[133] and this may have necessitated intervention from central government. In other words, an unfavorable finding would probably have blown up the Borough Council. Accordingly, while the decision in *Hammersmith* was not the preferred outcome for the industry, it had the effect of minimizing the potential for negative externalities for stakeholders beyond the industry.

The *Eternity* cases[134] arose after Argentina engineered voluntary debt exchanges with its bondholders in 2001.[135] The ostensibly voluntary nature of the arrangements prompted disagreement amongst market participants as to whether New York law-governed CDS contracts written against Argentine debt could be triggered. The main bone of contention was the definition of 'restructuring' under the 1999 ISDA Credit Derivatives Definitions.[136] Certain market participants complained that it was unclear as to whether the relevant definition covered a voluntary exchange of the type entered into by Argentina in the 2001 period.

JPMorgan, a protection seller, adopted the view that this situation did not fall within the definition of restructuring and refused to pay out on the CDS contracts it was party to. One of its counterparties, Eternity Global Master Fund, a protection buyer, asserted otherwise, alleging that although the debt exchanges were ostensibly voluntary, effectively there had been 'economic coercion' of the bondholders. Eternity sued JPMorgan for breach of contract.[137]

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[132] *See e.g.*, *Kleinwort Benson Ltd* v *Lincoln City Council & Ors* [1998] 3 WLR 1095; *Westdeutsche Landesbank Girozentrale* v *Islington London Borough Council* [1996] AC 669; *Morgan Grenfell* v *Welwyn Hatfield District Council* [1995] 1 All ER 1.

[133] Alastair Hudson, *Dealing with Derivatives* (on file with author).

[134] *Eternity Global Master Fund Ltd.* v *Morgan Guaranty Trust Co. of N.Y.* 375 F.3d 168, 182 (2nd Cir. 2004); *Eternity Global Master Fund Ltd.* v *Morgan Guaranty Trust Co. of N.Y.*, No 02 Civ.1312 (LMM)(GWG), 2003 WL 21305355 (S.D.N.Y. June 5th, 2003); *Eternity Global Master Fund Ltd*. v *Morgan Guaranty Trust Co. of N.Y.*, No. 02 Civ.1312(LMM), 2002 WL 31426310 (S.D.N.Y. Oct. 29, 2002) [hereinafter litigation].

[135] *See e.g.*, Anna Gelpern, *After Argentina,* 2005-PB05-2 Institute for International Economics Working Paper (2005), available online at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=880794 (last accessed: 1 December 2012). On the dynamics of sovereign debt restructurings more broadly, *see* Udaibir Das, Michael Papaioannou & Christoph Trebesch, *Sovereign Debt Restructurings 1950-2010: Literature Survey, Data and Stylized Facts* (IMF Working Paper 12/203, August 2012), available online at: http://www.imf.org/external/pubs/ft/wp/2012/wp12203.pdf (last accessed: 1 December 2012).

[136] For further discussion, *see* Gelpern & Gulati, *supra* note 16.

[137] *See* list of litigation cases, *supra* note 134.

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At first instance, the SDNY judge deemed the 1999 ISDA Credit Derivatives Definitions ambiguous but dismissed Eternity's breach of contract claim.[138] In lieu of a ruling in an appeal mounted by Eternity following dismissal of the breach of contract claim by SDNY, ISDA responded quickly and executed a revision through the 2003 ISDA Credit Derivatives Definitions specifying that a voluntary debt exchange would not typically trigger a credit event.[139] Accordingly, in this case SDNY signaled that an aspect of the private ISDA standard was ambiguous for members of the private regulatory regime and users of that standard; prompting ISDA to take action.

The use of OTC equity derivative instruments (where the 'underlying' asset or 'reference' is company shares) to evade disclosure of interests in corporations has been a major concern for academics and public regulatory authorities for some time. OTC equity derivatives can facilitate the building of 'stealthy' or 'hidden' ownership of corporations and/or permit 'empty voting'. Hidden ownership refers to economic, without legal, interest in shares but with the potential to exercise *de facto* control of the 'underlying' shares. Empty voting refers to legal, without partial or full economic, interest in shares. Both hidden ownership and empty voting may be capable of inefficiently skewing incentives in the market for corporate control, undermining the interests of regular shareholders, as well as stakeholders more broadly.[140]

Chief amongst the benefits of hidden ownership for OTC market participants has been a perceived lack of obligation to disclose hidden positions in OTC equity derivatives under existing public regulatory schemes. However, in *CSX* v *the Children's Investment Fund Management (UK) LLP*[141] SDNY found that the defendants had violated US securities legislation by intentionally entering into OTC equity derivatives contracts in order to avoid public disclosure requirements. This decision was reached notwithstanding the protestations of ISDA in its amicus brief[142] and sent the industry into a tizzy.[143] Therefore,

[138] James Warnot & Justin Williamson, *ISDA Definitions Unclear, Says U.S Court*, 23 INT'L FIN'L L. REV. 27 (2004).

[139] For discussion, *see e.g.*, Daniel Hemel, *Empty Creditors and Debt Exchanges*, 27 YALE J. ON REG. 159, 162 (2011); Jongho Kim, *From Vanilla Swaps to Exotic Credit Derivatives: How to Approach the Interpretation of Credit Events*, 13 FORDHAM J. OF CORP. & FIN'L L. 705 (2008).

[140] *See e.g.*, Blanaid Clarke, *Where Was the Market for Corporate Control When We Needed It?*, *in* CORPORATE GOVERNANCE AND THE GLOBAL FINANCIAL CRISIS: INTERNATIONAL PERSPECTIVES, (William Sun, Jim Stewart & David Pollard eds., 2011); Henry Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions,* 156 UNIV. OF PENN. L. REV. 625 (2008); Shaun Martin & Frank Partnoy, *Encumbered Shares*, 3 UNIV. OF ILL. L. REV. 775 (2005).

[141] *CSX Corporation* v *the Children's Investment Fund Management (UK) LLP & Others* (08 Civ. 2764 (LAK) (SDNY, 11 June 2008)).

[142] ISDA, *Amicus Briefs*, available online at: http://www2.isda.org/functional-areas/legal-and-documentation/amicus-briefs (last accessed: 1 December 2012).

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in this selection of earlier cases (*Hammersmith*, *Eternity* and *CSX*), national public courts in England and New York demonstrated that they were not prepared to absolutely defer to private legal rules or norms,[144] particularly where a broader public interest was at stake. Of course, in many other cases the English and New York courts have in fact reached the 'right result' from the industry's perspective.[145]

However, while *Hammersmith*, *Eternity* and *CSX* were examples of how national public courts, including in England and New York, could induce occasional challenges for the industry, such cases were arguably sufficiently few and far between for the industry to manage prior to the GFC. But the bankruptcy of Lehman Brothers in 2008 raised the prospect, in theory at least, of far more extensive, and potentially disruptive, litigation for the OTC derivatives industry. While Lehman has recently emerged from bankruptcy, there remain a large number of claims and lawsuits to be resolved and some of the most high-profile of these lawsuits are expected to reach full trial.[146] Nonetheless, some of the actual outcomes so far have perhaps been less traumatic than the industry may have feared.

For example, in April 2012 the aforementioned Lehman Brothers suit against JPMorgan Chase in relation to the alleged illegal seizure of collateral during Lehman's death throes was partially dismissed.[147] It is notable that ISDA waded into that case in support of JPMorgan.[148] ISDA has also applauded the outcome in other joined cases before the English Court of Appeal which were linked to the collapse of Lehman Brothers and in which ISDA

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[143] For discussion, *see e.g.*, Daniel Bertaccini, *To Disclose or Not to Disclose? CSX Corp., Total Return Swaps, and Their Implications for Schedule 13D Filing Purposes,* 31 CARD. L. REV. 267 (2009); Brian Sullivan, *CSX Corp. v Children's Investment Fund Management and the Need for SEC Expansion of Beneficial Ownership*, 87 NORTH CAR. L.. REV. 1300 (2009).

[144] For further discussion in a similar vein *see e.g*., Frank Partnoy, *ISDA, NASD, CFMA and SDNY: The Four Horsemen of Derivatives Regulation?* (Brookings-Wharton Papers on Financial Services, 2002).

[145] S.K. Henderson, *Credit Derivatives and Operational Risk, or Why a Credit Default Swap is Not Like a Bond*, 1 L. AND FIN'L MKTS REV. 31 (2007).

[146] *See* Caroline Humer, *Lehman Emerges from 3.5 Year Bankruptcy*, REUTERS (6 March 2012), available online at: http://www.reuters.com/article/2012/03/06/us-lehman-idUSTRE8250WY20120306 (last accessed: 1 December 2012).

[147] Linda Sandler, *JPMorgan Wins Narrowing of $8.6 Billion Lehman Lawsuit*, BLOOMBERG (20 April 2012), available online at: http://www.bloomberg.com/news/2012-04-19/jpmorgan-wins-narrowing-of-8-6-billion-lehman-lawsuit-1-.html (last accessed: 1 December 2012).

[148] ISDA, *Amicus Brief in Lehman Brothers Holdings Inc.* v *JPMorgan Chase Bank, N.A.* (2 February 2011), available online at: http://www2.isda.org/functional-areas/legal-and-documentation/amicus-briefs/ (last accessed: 1 December 2012).

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acted as amicus.[149] However, notwithstanding favorable outcomes in some of the Lehman Brothers-related litigation, the mere *fact and extent* of the litigation in the first place may have been sufficient to seriously rattle the OTC derivatives industry. Furthermore, until the outstanding Lehman-related litigation is finally resolved,[150] the industry may remain somewhat on edge.

The Lehman litigation has thus arguably, at a minimum, reminded the OTC derivatives industry of the potential lack of certainty in formal litigation, even in 'OTC derivatives friendly' jurisdictions. Moreover, the industry will undoubtedly be concerned that public courts are now shining torches into the nature of certain industry interactions and private regulatory crevasses which, prior to the GFC, may have been, to a large extent, off-bounds.

VII. The Limitations of ISDA's Role in Minimizing 'Interpretative Interference'

As suggested by Frank Partnoy, ISDA standards have traditionally benefited from at least indirect public recognition of their market authority by national legislators. As Partnoy observes:

> [N]umerous statutes and regulations rely on certain provisions that are incorporated into standard form OTC derivatives counterparty contracts, even though they do not explicitly reference ISDA. Such reliance on ISDA terms, albeit not explicitly reliance on ISDA, is a sign that ISDA standards are very strong.[151]

As a result, it makes sense for industry that ISDA leverages its credibility and expertise as amicus in certain derivatives cases before the courts. As has been observed by Anna Gelpern, and as was evident in the *CSX* case and Lehman Brothers litigation, where ISDA has intervened it has typically done so in 'regulatory and bankruptcy settings, where the group has essentially reiterated its positions against regulation...siding with members against regulators and trustees'.[152] Gelpern also contends that:

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[149] ISDA, *ISDA Welcomes the English Court of Appeal's Decision to Uphold ISDA Master Agreement in LBIE Judgement* (3 April 2012), available online at: http://www2.isda.org/news/isda-welcomes-the-english-court-of-appeals-decision-to-uphold-isda-master-agreement-in-lbie-judgment (last accessed: 1 December 2012).

[150] *See e.g.*, Linda Sandler, *JPMorgan Sued by Lehman Over $2.2 Billion Derivatives Claims*, BLOOMBERG (17 September 2012), available online at: http://www.bloomberg.com/news/2012-09-17/jpmorgan-sued-by-lehman-over-2-2-billion-derivatives-claims-1-.html (last accessed: 1 December 2012).

[151] Frank Partnoy, *Second-Order Benefits from Standards*, 48 BOST. COLL. L. REV. 169, 187 (2007).

[152] Anna Gelpern, *Commentary: Public Promises and Organizational Agendas*, 51 ARIZ. L. REV. 57 (2009).

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> 'ISDA's legislative and litigation posture has steadfastly discouraged functional and contextual analysis of its contracts by judges...it asks the court to fix and police the outer boundary of private regulation, not to interfere in its substance, which remains in ISDA's domain'.[153]

As Partnoy has observed, ISDA itself may enjoy 'second-order benefits' from these activities. However, ISDA's interventions to shore up its regulatory regime, such as through amicus briefs, may not be sufficient for members in the longer term. Ultimately, it is clear that ISDA and the industry have not been entirely successful in preventing 'interpretative interference'[154] in the private regulatory regime. This may pose effectiveness and legitimacy challenges to the ISDA regulatory regime as a general matter, in conjunction with many other ongoing public regulatory reform challenges. These effectiveness and legitimacy challenges will be discussed in the next section, followed by consideration of a recent industry initiative which may be a response to this.

VIII. When the Proof of the Pudding is in the Eating: Effectiveness and Output Legitimacy Implications of ISDA Audiences

Regulatory effectiveness refers to the extent to which a regulatory regime achieves its policy goals and may be a key measure of 'output legitimacy'. Therefore, it is feasible to suggest that a regulatory regime can be effective for certain constituencies, despite poor 'input legitimacy'. In the ISDA context, effectiveness and output legitimacy may be subject to challenge given the limitations of targeted touchdown and the constant potential for public interpretative interference[155] through adverse, or not entirely favorable, court findings.

Invoking the 'organizational audiences' frameworks elaborated by Mark Suchman[156] and Benjamin Cashore, measuring the effectiveness and legitimacy of a private regulatory regime could be plausibly bifurcated between 'Tier 1' and 'Tier 2' audiences.[157] Tier 1 audiences who may be in a position to grant legitimacy to a private regulatory regime include, for example, its members, as they retain a direct and measurable interest in what the regulatory regime does. Tier 2 audiences might retain an ostensibly indirect interest in

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[153] Gelpern, *supra* note 152.

[154] Black & Rouch, *supra* note 4.

[155] *Id.*

[156] Mark Suchman, *Managing Legitimacy: Strategic and Institutional Approaches*, 20 ACAD. OF MNGM'T REV. 571 (1995).

[157] Benjamin Cashore, *Legitimacy and the Privatization of Environmental Governance: How Non-State Market-Driven (NSMD) Governance Systems Gain Rule Making Authority*, 15 GOVERNANCE 503, 511-512 (2002).

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what the private regulatory regime does but also play an important role in underpinning regulatory effectiveness and bestowing legitimacy.

The Tier 2 audience might include national governments, society writ large and, importantly for present purposes, public courts. Cashore has pointed out that Tier 1 and 2 audiences can be linked.[158] Hence, it could be imagined that a private regulatory regime might only enjoy legitimacy from the perspective of its Tier 1 audience (its members) if the regulatory regime it oversees is seen as effective and thus satisfies 'output legitimacy'. But a private regulatory regime, particularly in the financial markets, may only be in a position to actually satisfy the 'output legitimacy' demands of its Tier 1 audience if the regime, or at least the aspects under scrutiny, are simultaneously deemed legitimate by its Tier 2 audience.[159] It is clear that aspects of the ISDA regulatory regime in practice rely upon the 'enrolment'[160] of external Tier 2 audiences to shore up the TPRER, including through favorable interpretation by public courts.

It is not suggested here that the ISDA regulatory regime has necessarily lost a devastating amount of effectiveness and output legitimacy as a result of a few adverse court findings and some uncertainty surrounding the Lehman Brothers litigation. There is a danger of overstating the point, particularly given that the ISDA regulatory regime is multifaceted and may draw effectiveness and legitimacy from other sources. Furthermore, the public regulatory environment for OTC derivatives more generally is currently rife with rhetoric; hence broader regulatory effectiveness and legitimacy questions remain to be settled.

Nonetheless, the issue of interpretative interference is sufficiently serious for the industry that, as ISDA has indicated, alternative dispute resolution (ADR) has become increasingly popular amongst OTC derivatives market participants in the wake of the GFC.[161] It is also evident that ISDA has been involved in an ambitious initiative which has recently come to fruition which seeks to divert litigation to private mediation and arbitration. This arguably confirms industry recognition of the limitations and uncertainty of formal dispute resolution (for the industry itself).

[158] Cashore, *supra* note 157, at 512.

[159] On a similar theme *see e.g.*, Isabelle Huault & Héléne Rainelli-Le Montagner, *Market Shaping as an Answer to Ambiguities: The Case of Credit Derivatives,* 30 ORG'N STUD. 549 (2009).

[160] Julia Black, *Enrolling Actors in Regulatory Processes: Examples from UK Financial Services Regulation*, PUB. L. 62 (2003).

[161] ISDA, *The Use of Arbitration under the ISDA Master Agreement: Feedback and Policy Options* (10 November 2011), available online at: http://www2.isda.org/search?keyword=arbitration (last accessed: 1 December 2012).

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IX. PRIMING for Battle: P.R.I.M.E Finance

Firstly, it should be highlighted that in the wake of the *Eternity* cases and particularly after Lehman and AIG keeled over, new industry-populated bodies for determining and settling CDS triggering events were established by ISDA. These are known as the ISDA Credit Derivatives Determinations Committees (DCs). Because of their peculiarity to the CDS markets, the ISDA DCs are not considered in further detail as they have been well treated elsewhere.[162] But what can be safely suggested is that the DCs arguably represent one prong of ISDA's strategy to shut public courts out of the OTC derivatives markets as far as possible. However, this does not definitively address the problem, from ISDA's perspective, of troublesome public courts interfering in the broader OTC derivatives markets; or even the CDS markets for that matter. Therefore, the industry has decided that something more is needed.

In January 2012, a mediation, arbitration and training body, the Panel of Recognized International Market Experts in Finance (P.R.I.M.E. Finance), was officially established in The Hague.[163] The establishment of PRIME Finance was the result of a number of writings and engagements between leading academics, members of the legal profession and industry participants dating to 2009[164] and possibly earlier. The wheels were apparently set in motion following a call by a round table meeting of lawyers and financial experts, organized by the World Legal Forum in October 2010,[165] to establish a tribunal for financial market ADR.

It is obvious that the objective of P.R.I.M.E. is to corral disputes over complex financial contracts to P.R.I.M.E. for mediation and, if necessary, binding arbitration. P.R.I.M.E. Mediation and arbitration processes are influenced by United Nations Commission for International Trade Law (UNCITRAL) standards.[166] The initiative is being supported by high

[162] Particularly in Gelpern & Gulati, *supra* note 16.

[163] P.R.I.M.E. Finance, *About Us*, available online at: http://www.primefinancedisputes.org/index.php/about-us (last accessed: 1 December 2012).

[164] P.R.I.M.E. Finance, *Press Coverage*, available online at: http://www.primefinancedisputes.org/index.php/news-blog/press-coverage (last accessed: 1 December 2012).

[165] World Legal Forum, *Call for the Establishment of an International Dispute Resolution Facility for the Financial Markets in the Hague* (25 October 2010), available online at: http://www.primefinancedisputes.org/images/WLF_20101025_Press_Financial_Roundtable.pdf (last accessed: 1 December 2012).

[166] P.R.I.M.E. Finance, *About PRIME Finance Arbitration Rules*, available online at: http://www.primefinancedisputes.org/index.php/arbitration (last accessed: 1 December 2012); P.R.I.M.E. Finance, *About PRIME Finance Mediation Rules*, available online at: http://www.primefinancedisputes.org/index.php/mediation.html (last accessed: 1 December 2012).

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profile figures from academia, the legal profession and industry.[167] On paper at least, P.R.I.M.E. Finance appears to be credible at this early stage and it may well morph into an influential dispute resolution body in time.[168]

According to available information, ISDA is heavily involved in this initiative. For instance, it is notable that P.R.I.M.E. Finance's panel of 'Finance Experts' is populated by a slew of ISDA alumni, as well as at least two current senior ISDA officials.[169] If or when P.R.I.M.E. Finance clearly establishes itself as an authority on resolving disputes in complex financial transactions, it may offer a useful avenue for ISDA's attempts to minimize distracting public interpretative interference[170] in its TPRER. Nevertheless, while P.R.I.M.E. Finance may facilitate at least 'partial liftoff' from national legal systems, it is unclear, as Wai has argued, whether transnational business contracts, including those incorporating commercial mediation and arbitration clauses, can always avoid crashing down to national courts at some point; insofar as contestation over procedures within such private ordering may only be resolvable at national courts.[171]

E. Conclusion

This paper has attempted to connect the dots of dispute resolution and enforcement dynamics in the ISDA TPRER. ISDA and the industry seek to ensure, what I term 'targeted touchdown' (drawing on the work of Robert Wai), of disputes under the ISDA Master Agreement in the 'derivatives friendly' jurisdictions of England and New York. However, this has not been sufficient in itself to prevent national public court 'interpretative interference'[172] on key issues for the private regulatory regime. Furthermore, the threat of such interference following the collapse of Lehman Brothers has been resurrected on a scale which could be a thorn in the side of the industry. This risk is also unlikely to entirely dissipate at the end of the Lehman Brothers saga. If a Eurozone state were to default

[167] P.R.I.M.E. Finance, *Dispute Resolution Experts*, available online at: http://www.primefinancedisputes.org/index.php/expert-list (last accessed: 1 December 2012).

[168] For a good overview of existing literature on PRIME Finance, *see* P.R.I.M.E. Finance, *Press Coverage*, available online at: http://www.primefinancedisputes.org/index.php/news-blog/press-coverage.html (last accessed: 1 December 2012).

[169] P.R.I.M.E. Finance, *Finance Experts*, available online at: http://www.primefinancedisputes.org/index.php/expert-list/financial-experts.html (last accessed: 1 December 2012).

[170] Black & Rouch, *supra* note 4.

[171] Wai (2008), *supra* note 119.

[172] Black & Rouch, *supra* note 4.

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and/or exit the Eurozone altogether at some point, the contract-related headache for the industry generated by Lehman Brothers would likely pale in comparison.[173]

This article has suggested that interpretative interference or even *the threat* of such interference by public courts may serve to undermine the effectiveness and output legitimacy of the ISDA regulatory regime in the longer term. Therefore, industry support for a new alternative dispute resolution mechanism (embodied in P.R.I.M.E Finance) which could help keep OTC derivatives disputes more exclusively in the private realm, is understandable from an industry perspective. Nonetheless, due to the backstopping role of public courts, OTC derivatives market participants may only be capable of achieving 'partial liftoff' from worrisome formal court-based enforcement processes.

[173] ISDA, *Eurozone Contingency Planning*, available online at: http://www2.isda.org/functional-areas/legal-and-documentation/eurozone-contingency-planning/ (last accessed: 1 December 2012).

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