

Derivatives Documentation For Energy End Users

Law360, New York (June 6, 2011) -- For many years, participants in over-the-counter derivatives markets have had a predictable and generally fair set of alternatives for documenting their trades. The vast majority of market participants used the ISDA Master Agreement — in recent years, using either the 1992 or 2002 form of the agreement. In certain other niches, such as energy and commodity trading, other standard form contracts governed.

In the coming months, most of those market participants will see dramatic changes in their derivatives documentation. Although purely physical commodity trades will remain on pre-existing forms and while certain may remain on ISDA master agreements, many new derivatives transactions will be documented on forms of contracts that may be new to many players. These forms of contracts may allow for less negotiation by energy end users and may differ materially from the ISDA terms and conditions to which they have become accustomed.

To engage in commodity swap transactions that will be subject to the mandatory clearing requirement of the Dodd-Frank Wall Street Reform and Consumer Protection Act, swap transactions will have to be cleared through derivatives clearing organizations (DCOs or Clearinghouses).

Certain swaps — such as those for which no clearing is available or that an end user counterparty prefers not to clear — likely will be documented in the present method, although the parties will need to ensure that they have a credit support arrangement in place. All swaps subject to mandatory clearing will be executed on a designated contract market (DCM) or swap execution facility (SEF), if either is available for trading such swaps. Moreover, customers clearing swaps will be required to post initial and variation margin in support of such transactions.

In most cases, a swap that is required to be cleared will be entered into on either a DCM or a SEF and then submitted to a DCO for clearing. That submission will take place through futures commission merchants (FCMs) that are clearing members of a DCO.

The actual documentation used by the market participant will often be governed by its choice of FCM. Documentation for cleared swaps will generally consist of a futures account agreement, a cleared derivatives transaction addendum, and a cleared derivatives transactions execution agreement (collectively, cleared swaps documentation). Generally, each FCM will have its own form of a futures account agreement. Although the various forms likely will appear to be similar, minor changes may become significant – and more importantly, the changes from the ISDA master agreement to the cleared swaps documentation may be quite significant.

Overview of the ISDA Master Agreement Documentation

An ISDA master agreement typically consists of the form contract, a schedule in which changes are made to the master agreement, a credit support annex and a Paragraph 13 in which changes are made to the CSA. One hallmark of the structure is for the master agreement and the CSA to provide structure, while the schedule and Paragraph 13 provide flexibility for bilateral negotiations.

For example, the 1992 master agreement does not expressly provide for setoff rights. Because setoff is an important contractual right to many market participants, it is commonly included in schedules to the 1992 master agreement. This modification reflects the flexibility of the contractual framework, and the ability of the parties to tailor the agreement to suit their needs. Generally, parties make many modifications in the Schedule and Paragraph 13 — some of which are commonplace throughout the industry, and some of which reflect individual needs of one party to the agreement.

Cleared Swaps Documentation

In contrast, futures account agreements tend to be considerably less bilateral in nature. Instead, FAAs have typically been developed by an individual FCM, and are offered to its customers on a much more take-it-or-leave-it basis. Some large market participants may succeed in negotiating a handful of terms of their FAAs, but more often, FCMs will strenuously resist the customization of their FAAs.

Accordingly, market participants' power rests more in their choice of FCMs, as opposed to in their negotiation of contractual terms. In order to make an informed choice about which FCM to use as a clearing member of the DCO, players should obtain the cleared swaps documentation from each FCM they are considering. A careful analysis of the documentation may reveal many differences, but certain important factors are discussed below.

1) Events of Default

FAAs include some events of default that will be familiar to users of the ISDA master agreement, such as breach of representations and certain insolvency events. In addition, though, there may be a number of other “events of default” that would seem incompatible with most OTC players' understanding of the term. For example, many FAAs include a discretionary default — i.e., if an FCM, in its discretion, deems it necessary or desirable for its protection, then it may declare a default.

Another issue is that many FAAs provide for an “event of default” if the customer defaults on any other agreements between the customer and the FCM. Some even extend such an “event of default” to the customer’s defaults under other agreements with the FCM’s affiliates. Such a default provision is similar to certain cross-default provisions negotiated in the ISDA master agreement and schedule.

To the extent that a market participant can negotiate the terms of its cleared swap documentation, the scope of the default provisions would be an important term for it to focus upon. If it cannot negotiate those terms, then risk management decisions will need to be made based on an understanding that an FCM can declare a default at any time.

2) Assignment

Similarly, FAAs generally provide that an FCM can assign the FAA without customer consent. The FAAs do not, however, typically allow a customer to assign the FAA to another customer. Even if assignment is permitted by the customer, it will generally be only with written consent of the FCM. If negotiation is possible, energy companies may want to seek reciprocity in the assignment provisions.

3) Position Limits

The issue of position limits may extend beyond the restrictions implemented by the [CFTC](#), other regulators, or even the Clearinghouses. A Futures Account Agreement may authorize an FCM to limit the number of contracts that it will execute, clear and/or carry for a customer at any given time. Under such provisions, the FCM may exercise its discretion without regard to limits established by the CFTC or the relevant Clearinghouse. This is significant because under FAAs, an FCM can effectively terminate its Futures Account Agreement, in whole or in part, with a customer.

4) Treatment of Collateral

Under the Commodity Exchange Act, any funds received by an FCM from a customer in connection with futures contracts must be segregated, set aside or held in a separate account from the assets and funds of the FCM. The FCM may, however, commingle all of its customers’ funds in one account. The attendant risk of a shortfall in that single account is called “fellow-customer risk” – which arises when a customer defaults and the FCM is unable to fully satisfy its obligations to the Clearinghouse. Potentially, the Clearinghouse may look to remedy the default from the non-defaulting customers’ funds contained in a customer segregated account.

Guarding against fellow-customer risk is essentially a matter of monitoring the FCM’s financial stability and its risk profile vis-à-vis its customers. To the extent that the CFTC does not require safeguards against fellow-customer risk, market participants might seek to implement contractual provisions to facilitate such monitoring.

Conclusion

For many market participants, entering into cleared swaps documentation will be a radical departure from the level playing field of the ISDA master agreement. Whereas the master agreement provided an opportunity for the parties to negotiate terms in accordance with their individual needs and relative bargaining power (often with a resulting reciprocity of rights between the parties), the cleared swaps documentation may be more a matter of selecting an FCM with the least onerous FAA provisions. Customers of FCMs should be careful and wary of one-sided provisions in the cleared swaps documentation, and should make every effort to negotiate as many terms as the FCM will allow.

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