Stockholm Arbitration Yearbook 2020

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CHAPTER 2

ISDA and ADR: A Brief History of a Long Relationship

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ISDA[1] has been an effective proponent of, and exercised thought leadership regarding, alternative dispute resolution (ADR) for more than three and a half decades – since the formation (actually before that) of ISDA itself.

That may surprise many. When ISDA first published its Arbitration Guide in 2013, it was said to offer a window on a potential change in thinking; an *alternative* to the more traditional preference in the financial markets for court determination of party disputes.[2]

* The author gratefully acknowledges the assistance of Hannah Fry, LLB, LLM, a barrister at 3 Hare Court Chambers, in preparing this chapter for publication.

1. The International Swaps and Derivatives Association, Inc. (and until 1993 the International Swap Dealers Association, Inc.). ISDA was founded in 1985 by a group of commercial, investment and merchant banks for the purpose of standardising contracts and contractual language for OTC derivatives.
2. ISDA, *2013 ISDA Arbitration Guide* (9 September 2013), http://www2.isda.org/functional-areas/public-policy/financial-law-reform/, at 2.2. 'Historically, international financial transactions have tended to be documented under agreements governed by English or New York law and which contain jurisdiction clauses conferring jurisdiction on the English or New York courts.' For more background on this Guide, *see also* Jeffrey Golden and Peter Werner, *The Modern Role of Arbitration in Banking and Finance*, in Golden and Lamm (eds.), *International Financial Disputes: Arbitration and Mediation* (Oxford University Press, 2015).

   The Guide, when it first appeared in 2013, captured a lot of attention. *See*, e.g., client bulletins such as Slaughter and May, https://www.slaughterandmay.com/what-we-do/publications-and-seminars/publications/client-publications-and-articles/i/isda-arbitration-the-final-lap/; Clifford Chance, https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2013/09/arbitration-in-swaps-and-derivatives-new-guidance-from-isda-17-september-2013.pdf; Allen & Overy, https://www.allenovery.com/en-gb/global/news-and-insights/european-finance-litigation-review/eu-developments/idsa-drafts-model-arbitration-clauses-for-use-with-master-agreements. Much of that commentary viewed the Guide as offering a possible

But in fact, ISDA and its documentation represent a long effort by the derivatives markets to minimize the role of courts,[3] at least for any disputes related to the terms or operation of the parties' agreement itself[4] – certainty, speedily delivered, often being preferred even, at least in the abstract, over justice.[5]

Why did this embrace of ADR go unnoticed for so long? For years, relatively few derivatives market disputes were reported. And those that did arise tended to relate to matters outside the contract, which did not trigger the ADR mechanisms in it. For example, in *Hazell v. Hammersmith and Fulham London Borough Council*, one of the more significant early decisions that came before the UK House of Lords, the case was not so much a dispute about how the parties' swap agreements should be interpreted or the measure of any payment under them but rather whether the swaps were beyond the legal capacity of a local authority such that their swap agreements were unenforceable and any transactions contemplated by them were *void ab initio*.[6]

That changed with the global financial crisis that began in 2008, and particularly the Lehman litigation (with the considerable focus on interpretation of contractual damages provisions) that flowed from it.[7] And there can be little doubt that a growing interest in arbitration throughout the ISDA world in the early part of the last decade was a reaction to the cost and expense of the cases arising from that crisis.

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change in direction. *See*, e.g., Latham & Watkins, https://www.lw.com/thoughtLeadership/lw-ISDA-Arbitration-Guide-2013 ('Whereas financial institutions historically took a more conservative approach – clearly preferring litigation in state courts over arbitration – the introduction of the optional arbitration clauses represents yet another milestone showcasing that the financial industry is discovering arbitration as an alternative to litigation.'); IFLR.com, https://www.iflr.com/Article/3437078/Rise-of-alternative-OTC-dispute-venues.html ('Traditionally litigation has been the preferred form of dispute resolution in international finance.')

The popularity of the 2013 ISDA Arbitration Guide incentivized ISDA to publish a second, expanded version in 2018. *2018 ISDA Arbitration Guide*, https://www.isda.org/a/5kDME/ISDA-2018-Arbitration-Guide.pdf.

3. *For example,* through binding party self-determinations (contractual privilege), the role of the calculation and valuation agents (especially as mediators 'after consultation') and screen and published pricing sources (that often fall back to reference banks to resolve pricing issues). *See* discussion at *infra* nn. 24–26 and accompanying text.
4. In fact, the earliest court cases raised issues outside of the parties' contractual terms, relating to formation, contract validity, party relationships and taxation. The markets were comfortable referring issues of this kind to the courts. The greater concern related to disputes about the interpretation of language within the contract.
5. *See* discussion at *infra* n. 23 and accompanying text.
6. *Hazell v. Hammersmith and Fulham London Borough Council* [1992] 2 A.C. 1. There has been an evolution in the kinds of cases that we see coming to the courts. As reported in *supra* n. 4, the earliest cases raised issues that judges were often familiar with from other cases: e.g., authority, capacity, duty of care, contract formation. These cases continue. However, more recently the battle has focused on language within the contract itself and its application, often a very highly technical and scientific business, to market practices (which in turn have varied over time): e.g., valuation, formulaic calculations, assessment of 'commercial reasonableness' of operations/procedures in the markets or subsets of them.
7. A research project conducted by Dr Joanne Braithwaite at the London School of Economics and Political Science confirmed that a total of seventy-eight decisions involving ISDA documentation were handed down by the English courts alone during the period 1 January 1993 to 5 August 2011 but of these 60% occurred between 2009 and 2011. Joanne P. Braithwaite, *Derivatives, the Courts and Regulatory Reform*, Capital Markets Law Journal 7(4) (2012), 1–22, available at: http://cmlj.oxfordjournals.org/content/early/2012/09/21/cmlj.kms033.full?keytype = ref&ijkey = uwjPs64CzTOXiza.

Around this time interest increased as well in specialist financial courts and the need for more training in finance for judges – the markets just could not wait many years for answers, as they had done with much of the Lehman court litigation.

§2.01 AN EARLY COURTSHIP: DEVELOPMENT OF THE CONCEPT OF 'AGREEMENT VALUE'

Little appreciated though it may be, the fact is that from the start (or before the start, depending upon from when you count) the early architects of the derivatives market-place who became the founders of ISDA hoped to achieve a scheme of things that would, as best possible, keep things out of courts. The aim was to look instead to the markets themselves, and to market participants, for market-sensitive answers to matters of potential or actual disputes, particularly where the answers would directly impact market behaviours and practice.

One particular ambition, at least in the pre-ISDA dollar interest rate market, was to avoid the time and expense of having to *prove* damages. But how, for example, to keep any measure of a claim for post-default damages from being capable of being second-guessed by a court? The answer was thought to be to pre-empt the court by having the parties agree *at the time of contracting* and as a 'pre-estimate' on the approach as to just how any such damages following default would best be calculated or, in other words, to insert a 'liquidated damages' provision.

When it first appeared in the mid-1980s, ISDA documentation began not as a master agreement or a contract but rather as a 'code': publication of standard wording for terms and definitions that the parties could incorporate, in whole or in part, in their own individual agreements.[8]

An article[9] based on interviews with a working group of the founders of ISDA (but before ISDA's incorporation) that produced the code gives insights into this search for an alternative to more traditional methods of determining what one party owes the other on the premature termination of a swap.

Coming into those meetings, the small group of financial institutions in the room had taken a variety of approaches in their bespoke institutional documentation, and achieving a consensus as to the best way forward was going to be difficult without offering a menu approach. Where the article noted agreement could found was in the concept of a formula for liquidating damages. If such a formula could be achieved, it was thought to be preferable to general damages or indemnification provisions – the

8. ISDA was formed and first published documentation in 1985. Called the Code of Standard Wording, Assumptions and Provisions for Swaps (the '1985 Code of Swaps'), that publication was a collection of terms and provisions that functioned more like a dictionary and was intended to 'establish a uniform vocabulary for dollar rate swaps'. 1985 Code of Swaps at iv. Following the positive reception of the 1985 Code of Swaps, ISDA published a second expanded version in 1986 (the '1986 Code of Swaps' and, together with the 1985 Code of Swaps, the 'Codes'), which 'addresse[d] a number of subjects on which the 1985 Edition was silent'. 1986 Code of Swaps at v.
9. Christopher Stoakes, *Standardising Swaps Documentation*, International Financial Law Review IV(3) March 1985) at 11–15.

problem with such provisions being that 'they may have to be proved [in court], which can be expensive and time-consuming'.[10]

One idea that attracted particular interest and attention in the group was a somewhat innovative approach for *market*-determined liquidated damages, being championed by First Boston and Salomon Brothers, called 'agreement value'. As Thomas Jasper, the then Vice President at Salomon Brothers who went on to become the first Chairman of ISDA, explained: 'You find the cost of cover by calling certain dealers in the interest-exchange market to find the price for a buyer or seller swap.'[11] And as another banker also quoted in the article confirmed, 'You terminate the transaction and get quotes from leading swaps participants to assume the rights and obligations of the defaulting party.'[12]

The result of such discussions, as reported from that working group and introduced by ISDA in its codes, was what became the defined concept of 'Agreement Value'.[13] It was based on third-party resolution of the post-default damages issue but was initially thought, for reasons of wider market illiquidity, to have limited relevance beyond the universe of straightforward 'plain vanilla' dollar interest rate swaps.[14] However, as markets for other derivatives products grew over time, so too grew a wider interest in this approach.

As a result, though perhaps underappreciated as an ADR mechanism, Agreement Value put down a marker thirty-five years ago for the relevance of non-judicial, third-party determinations in fixing post-default damages. Reliance in this way on

10. *Id.* at 12.
11. *Id.*
12. *Id.*
13. '*Measure of Damages.* For purposes of determining the amount payable on an Early Termination Date:

    "Agreement Value" means that on the Early Termination Date, if there is a Defaulting Party … that party will be obligated to make a payment to the other party in the amount, if any, by which the 'Market Quotation determined by the other party exceeds zero … .

    "Market Quotation" means … an amount determined on the basis of quotations from Reference Market-makers … .'

    Sections 12.1 and 12.2 of the 1986 Code of SWAPS.
14. Other issues that the working group had grappled with related to ensuring the quality and validity of the quotations to be relied upon and next steps in the absence on a relevant day of the quotations sought; in other words, according to Patrick de Saint-Aignan of Morgan Stanley (and later ISDA's first Vice Chairman): 'Who should be quoting and on what basis; can you shop the market to your advantage; and what is the fallback if there is no market?' *Id.* at 13. Another 'formula' for liquidated damages, which was to become the fallback in the Codes for occasions when requested quotations were not forthcoming, was based on replacement or redeployment costs by reference to (i) the actual borrowing costs the non-defaulting party would incur to put in place an alternative asset that would produce the lost (fixed or floating) income stream and (ii) a discounting of the expected replacement payments based on a pre-agreed source for a suitable discount rate. However, the working group realised that the enforceability of these formula approaches to liquidated damages was untested in court, especially in a bankruptcy context when default was likely and the formula might matter most. In due course this would send ISDA on a world bankruptcy law tour seeking legal opinions, and where necessary law reform, in support of the enforcement of its close-out mechanics. Court support for the enforcement of ISDA's market-determined liquidated damages was also forthcoming. *See*, e.g., *Drexel Burnham Lambert Products Corp. v. Midland Bank PLX*, 1992 U.S. Dist. LEXIS 21223 (S.D.N.Y.); *BNP Paribas v. Wockhardt EU Operations (Swiss) AG*, [2009] EWHC 3116 (Comm); *Videocon Global Ltd. v. Goldman Sachs International*, [2016] EWCA Civ. 130.

leading market makers with a long-term interest in the credibility and commercial attractiveness of the marketplace itself increased the likelihood of practical and acceptable results on technical issues.

And it proved to be only the beginning of a commitment by ISDA members and the derivatives markets generally to explore alternatives to courts for resolving market disputes or matters with the potential of becoming disputes (and often of sizeable proportion because of the multiplicity of market participants trading on the basis of the same standard terms) in an expeditious, commercial and cost-efficient way.

§2.02 ENGAGEMENT AND MARRIAGE: THE ISDA MASTER AGREEMENTS

Following the publication of the Codes, ISDA turned its attention to other projects, including 'the development of standard documentation for currency swap transactions and suggested standard form agreements and confirmation telexes for various types of rate swap and currency swap transactions'.[15] In 1987, these projects culminated in the publication of two standard forms, entitled 'Interest Rate Swap Agreement' and 'Interest Rate and Currency Exchange Agreement' (collectively, the '1987 Forms'). These 'master agreements' have been revised and re-published twice since then: in 1992 (the '1992 Forms') and in a single consolidated form in 2002 (the '2002 Form' and sometimes referred to in this chapter collectively with the 1987 Forms and the 1992 Forms as the 'ISDA Master').[16]

15. 1986 Code of Swaps at v.

16. The ISDA Master is widely used as an industry standard and receives considerable attention in all leading treatises on law and practice in the derivatives markets. It has also been reported on and analysed in numerous articles, and increasingly it is the subject of graduate study and thesis writing. ISDA publishes user guidance for its forms in multiple languages. Schuyler K. Henderson, *Henderson on Derivatives* (2d ed., LexisNexis 2010) at 803 concludes that '[t]he ISDA master is perhaps the most successful financial form document ever, anywhere'. The author goes on to write: 'There cannot be any other standard document which governs as many transactions, with as much credit exposure among as many different parties with such beneficial results. This did not happen by chance.' *Id*. Hannes Schneider, former senior partner at the German law firm Hengeler Mueller, expresses, from a civil code perspective, the view that 'ISDA's master agreements have been widely accepted and used throughout the world. What has been accomplished may be described as no less than the creation of a global law by contractual consensus.' Daniel P. Cunningham & Craig T. Abruzzo, *Multibranch Netting – A Solution to the Problem of Cross-Border Bank Insolvencies 1* (International Bar Association 1995). And from the United States, Professors Choi and Gulati argue that '[e]ven in the absence of an ideal legislative body capable of incorporating the interests of all relevant industry participants for any given decision, sophisticated contracting parties may find close alternatives. ISDA, for example, provides a close approximation in the swaps and derivatives markets'. Stephen J. Choi & G. Mitu Gulati, *Contract As Statute*, Michigan Law Review 104 (2006), 1129, 1162. The ISDA Master Agreement's status as the industry standard has also been widely recognized by both domestic and foreign courts.

Whereas the Codes had provided standardized provisions and terminology that could be incorporated into bespoke contracts, each of the 1987 Forms offered derivatives counterparties standardized, off-the-shelf contracts that were intended to further 'simplify and accelerate the process of documenting swaps'.[17]

The concept of Agreement Value in the Codes had included the term 'Market Quotation', which described in largest measure the methodology for referring the question of termination damages to third-party dealers for determination. Market Quotation replaced Agreement Value as the term of art in both the 1987 Forms and the 1992 Forms and moved from being a choice on the menu to a preferred way of dealing – a 'default' mechanism which was presumed applicable absent the express election of the parties for it not to be. The idea of resolving what might otherwise have been disputed valuations in this way had clearly taken root in the markets at the time and so had the interest in characterizing, and achieving the status for, this approach as 'liquidated damages'.

As with its antecedent Agreement Value, Market Quotation reflects a desire to establish, at the time the parties enter into their agreement, a liquidated damages *formula* (i.e., as a reasonable pre-estimate of a methodology for later calculating losses) predicated on a payment measure determined to resolve valuations that might otherwise give rise to disputes – not by referral of these to a court for resolution on this basis, but rather on the basis of an averaging of quotations for replacement transactions from leading dealers. In other words, this is ADR by party agreement and in reliance on ADR by reference market makers.

There are certain mechanical aspects to the Market Quotation measure that must be followed, but the Market Quotation arrived at is intended to be a final and binding expert determination. And whereas a judge rendering such a determination of quantum might be expected to set out in his or her judgment the basis for such a determination, there is, for example, nothing in the Market Quotation contractual language that requires a dealer making its third-party valuation as a reference market maker to base its quote on any particular source or sources of information or data, or indeed to give an explanation of or justification for how its decision was reached.

Certainty, speed and finality were all thought to be key, and all in reliance on market expertise and reputation. Viewed at the time as a novel but creative way of providing for liquidated damages, it was also expected that these reference market makers would function as gatekeepers as well as perform a judge-like function.

They knew the workings of the ISDA Master and brought context and relevant experience to the task. Like arbitration, they offered the prospect of specialist determination and were thought to eliminate the need for cross-checking by more generalist courts. They also could be expected to add a measure of objectivity, if not fairness. That objectivity was expected to be grounded in commerciality too and not driven solely by

17. User's Guide to the Standard Form Agreements – 1987 Edition (ISDA) at 1. The intention was to allow counterparties to enter into one 'master agreement' that would set out the general terms of their trading relationship (e.g., representations and warranties, events of default and termination events, payment mechanics, *etc.*), and then execute letters of confirmation governed by the master agreement that would set out the business terms for each individual transaction.

stand-alone, naked pricing. Most importantly, leading dealers of the highest credit standing could be expected to be particularly sensitive to reputational risk, competitive pressures and regulatory concerns. In short, since the dealers asked to decide these matters had invested a lot in the system, they could be expected as a result to have a lot at stake and hopefully the system's best interests at heart.[18]

§2.03 THE VOWS: COMMERCIAL PURPOSES THAT ANIMATED THE DRAFTING OF, AND WERE INTENDED TO BE SERVED BY, ADR PROVISIONS IN THE ISDA MASTER

To understand this particular interest in, or even partial preference for, ADR by the derivatives markets in this way, several commercial drivers behind ISDA documentation need to be appreciated, and it may be useful at this juncture to try to summarize a couple of these.

[A] Mitigation of Costly and Lengthy Litigation

The status of the ISDA Master as a global industry standard these days is taken for granted.[19] However, its initial focus was exclusively on interest rate and currency products, and when it started to reach out to a wider derivatives marketplace – e.g., commodity-, equity- and credit-linked products – it, had to be a 'selling' document, intended to attract and grow the business being placed under it. Moreover, it must also be appreciated that the audience to which it was appealing in that earlier period needed both convincing and assurances.

Geographical and linguistic dividing lines were being crossed. For risk management purposes, financial institutions were asking many of their trading desks to 'cross the street', to use the ISDA Master to achieve for the wider institution the benefits of contractual netting and preferential capital treatment. That often meant abandoning historically more favoured forms, and there were also concerns about exposure to expensive and protracted litigation because of the 'tick-the-box' choice of New York or English law as the governing law of the contract and submission to the jurisdiction of New York or English courts that followed from that.

In relevant ISDA documentation working groups, especially among ISDA members and their counsel in meetings outside the US, there was particular concern voiced

18. Although the Market Quotation remedy had established its popularity, a more general indemnification alternative also stayed on the menu for use both as a fallback when quotations were unavailable or it was thought that any available quotation might produce a commercially unreasonable approach and where parties elected it often because they were trading illiquid products and it was thought that third-party quotations would not serve such thin markets.
19. The latest survey results from the Bank for International Settlements put the outstanding notional amount of trading for the global OTC derivatives market at more than USD 550 trillion, and it is thought that the largest part of it – perhaps more than 90% – trades pursuant to ISDA documentation and terms. *See* Statistical release: Semiannual OTC derivatives statistics at end-December 2019, Bank for International Settlements: Monetary and Economic Department, May 2020. https://www.bis.org/publ/otc_hy2005.pdf.

about extensive US-style discovery procedures and concomitant delays and costs. As a practical matter, if such concerns were not seen to be addressed or mitigated in the documentation, it might have been a serious impediment to the widespread and international buy-in to, and adoption of, the ISDA forms. In turn, that might have lost the economies, liquidity, wider market risk protection and other benefits of scale that have in fact been achieved over time. Accordingly, it was the drafters' ambition that the scope of the issues to be court determined, rather than party or leading dealer determined, would be narrow.

In short, ISDA wanted buy-in from a very diverse group – and that buy-in was by no means assured. Accordingly, Market Quotation (and the replacement remedy of Close-out Amount in the 2002 Form, which embraces and accommodates dealer quotations and also aims at liquidated damages[20]) represented a practical attempt by the ISDA drafters – a selling tool – to enhance the attractiveness of the use of the ISDA Master in the global derivatives markets by mitigating the risk of costly and protracted international discovery and litigation. A fear of crippling expenses that threatened the business model and unacceptable delays loomed large if instead the test required was to reach more of a fact-intensive, objective and court-instructed result.[21]

[B] Promotion of Certainty in the Global Markets

Market Quotation and Close-out Amount[22] also represent a practical attempt by the ISDA drafters to meet an equally compelling and overarching aim of fostering the ability of market participants to have certainty about their market risk position.

The marked reluctance to allow second-guessing by a court of any quotation received from a leading dealer acting as a reference market maker can only be understood if market interest in 'certainty' and the perceived difficulties, delays and

20. 2002 Form at s. 6(e)(v).
21. Counterparties are organized in many different jurisdictions around the world. In my opinion, the markets, by agreeing to the ISDA Master model, demonstrated a preference for the scope of the issues to be considered by the courts to be relatively narrow (e.g., good faith) in order, as the courts move from the ISDA Master between one set of parties to the next, not to have judges and juries micro-manage and align parties' behaviour and to avoid extensive and, given the international nature of the markets, inevitably expensive factual inquiries. Deference to determinations made absent a showing that they ignored expressly prescribed procedures or that they were capricious (i.e., a decision so irrational that no rational person could have taken it) or made in bad faith is part and parcel of the scheme of things. The commercial attractiveness of this way of doing business itself is paramount, for which a pre-agreed and bargained-for basis that even empowers one party to self-determine and liquidate any contractual claims without resort to the courts, if achievable, was seen as a real plus.
22. As drafters, our intention and instructions were that Close-out Amount should not so much change as borrow from the Market Quotation methodology a measure of damage based on replacement value but offer greater flexibility to the party making the determination. The need for flexibility had been highlighted in the market crises in 1998 and 1999 when many determining parties faced difficulty in obtaining the requisite third-party quotations. A wider source of relevant data was contemplated by the Close-out Amount definition, but it remained the intention of the ISDA working groups that the methodology contemplated would be treated, and qualify, as good liquidated damages.

costs encountered in otherwise discovering facts and confirming consensus in a global marketplace are fully appreciated.

In this author's experience, the markets have a marked preference for certainty even sometimes above justice and almost everything else. You can trade around a position that you know to be certain, however undesirable that position may be and whether or not you believe it to be fair. What is abhorred is not knowing where you stand. Eventually being told that you were correct in your earlier view, or a third-party view that you relied upon at the time, does not give a lot of comfort if you stand 'naked' to a market which has moved on and significantly against you while you waited for that answer or if you fixed a replacement hedge or transaction unnecessarily or at the wrong time.[23]

§2.04 THE WEDDING PARTY: CONTRACTUAL PRIVILEGE, CALCULATION AGENTS, VALUATION AGENTS, SCREENS AND REFERENCE BANKS

But there is more in the wider ISDA documentation library in support of these business purposes than just liquidated damages. Third-party dealers acting as reference market makers in the calculation of damages on close-out under the ISDA Master keep company with other third parties and third-party sources, introduced through the parties' trade confirmations and schedules, in a broader effort by the ISDA world to 'hermetically seal' the trading universe. In this universe, decisions are expected to be made to the largest extent for market participants by market participants with the commercial objective of keeping things out of court and mitigating the risk of expensive and protracted litigation.

While external pressures (reputational, commercial, regulatory) are expected to play their part, and non-defaulting parties enjoy considerable contractual privilege (i.e., the legal capacity afforded by the contract to make certain determinations choose the sources of data for certain calculations or do as one pleases in a certain matter), also relevant are 'calculation agents', who may be third parties tasked with pricing or valuing or otherwise exercising judgment, but very often after performing a mediation or conciliation role (i.e., 'after consultation with the parties').[24] Similarly, in separate

23. This commercial objective for certainty was, in my view, a fundamental rationale for the considerable discretion that the ISDA Master allows a non-defaulting party and the reference market makers when called upon to quote in a close-out situation. It was fully appreciated by the relevant ISDA documentation working groups that, by this point in time, an ISDA Master might be the umbrella for tens of thousands of trades. Setting specific times or prices was not the game. Neither was searching for correct or perfect (or even 'best') answers. If it turned out that, with the benefit of hindsight or more accurate information, a different (or more 'just') result might have been reached, that was unfortunate – but irrelevant.
24. The calculation agent's role usually sits outside the main body of the ISDA Master but comes in through the incorporation of definitional booklets or other product-specific terms in the confirmations of individual transactions. The duties of calculation agents, while largely ministerial in nature, can have significant consequence to the economics of trading between counterparties. A practice has evolved in which both parties can 'share' the role of calculation agent but provide for a dispute resolution process when agreement cannot be reached. The 2000

ISDA documentation for credit support, the role of the so-called valuation agent (and reference market makers) in connection with dispute settlement when margin calls are challenged is even more explicitly recognized.[25]

Similarly, the pricing and valuation mechanics in ISDA documentation for a great many products look to third parties (screen and published sources, reference banks (often as a fallback when a screen or published price is unavailable) and the like) for final and binding decisions, and without the involvement of courts even if the outcome may be perceived by one of the parties to be 'unfair'.[26]

ISDA Definitions contained a brief dispute resolution clause of this sort in the form of confirmation that is included as an exhibit – another example of ISDA embracing ADR along the way.

25. *See*, e.g., 1995 ISDA Credit Support Annex (Bilateral Form – Transfer) – *English Law* at para. 4:

> (a) *Disputed Calculations or Valuations.* If a party (a "Disputing Party") reasonably disputes (I) the Valuation Agent's calculation of a Delivery Amount or a Return Amount or (II) the Value of any transfer of Eligible Credit Support or Equivalent Credit Support, then:
>
> (1) the Disputing Party will notify the other party and the Valuation Agent … ;
>
> (2) in the case of (I) above, the appropriate party will transfer the undisputed amount to the other party …;
>
> (3) the parties will consult with each other in an attempt to resolve the dispute; and
>
> (4) if they fail to resolve the dispute …, then:
>
> (i) in the case of a dispute involving a Delivery Amount or Return Amount, unless otherwise specified … the Valuation Agent will recalculate the Exposure and the Value as of the Recalculation Date by:
>
> (A) utilising any calculations of that part of the Exposure attributable to the Transactions that the parties have agreed are not in dispute;
>
> (B) calculating that part of the Exposure attributable to the Transactions in dispute by seeking four actual quotations at mid-market from Reference Market-makers for purposes of calculating Market Quotation, and taking the arithmetic average of those obtained …; and
>
> (C) utilising the procedures specified [by the parties in their schedule] for calculating the Value, if disputed, of the outstanding Credit Support Balance;
>
> (ii) in the case of a dispute involving the Value of any transfer of Eligible Credit Support or Equivalent Credit Support, the Valuation Agent will recalculate the Value as of the date of transfer pursuant to [party agreed variables in the schedule].

26. This tolerance for unfairness and preference for certainty can be seen in a number of embraced market practices embedded in ISDA documentation. *See*, e.g., 2000 ISDA Definitions, s. 7.6. The referenced provision sets out the parties' agreement regarding corrections to published and displayed pricing sources. For example, where a relevant rate for a reset date is based on information from certain sources such as a Reuters screen page that rate is subject to corrections made by that source *but only if the correction is made within one hour of the time when such rate is first displayed*. After that, even if the displayed rate has an extra zero in it, and even if it is later corrected, it becomes the irrevocable basis for the relevant pricing of the transaction. That is the potentially harsh but, in order to ensure certainty, market preferred position!

§2.05 AN UNREQUITED LOVE AFFAIR[27]

In the period 1992–1993, ISDA actually flirted with the idea of going further and establishing its own arbitration/ADR facility. This was to stand alone, outside the agreement, and its remit would not just be limited to disputes about the ISDA Master or ISDA documentation.

In May 1992, at the behest of one of the Directors, the ISDA Board first discussed the potential role it could play as an arbiter of market disputes. After a brief preliminary discussion at the Board level, the matter was referred to ISDA's staff for a 'feasibility study', which was to include a review with ISDA's outside counsel of issues relating to liability.

Further consideration of this proposal was initially postponed, but two months later, at a dinner with US banking regulators, ISDA was urged to take a more active role in promoting good market practices. When the Board met the next day, ISDA's Chairman suggested that an arbitration service might be one way to respond to this suggestion from the regulators. As he envisioned it, the arbitration process would be informal and would not seek to produce legally binding decisions that would be enforceable in court. The suggestion was made that perhaps the Board should consider market practice statements as an alternative to an 'arbitration' service. It was the consensus of the Directors at the time that at the very least the arbitration service proposal should be refined further before reconsideration by the Board.

Momentum grew for some form of market practice dispute resolution facility in order to ensure that market practice issues were most likely to be decided by market practitioners in accordance with market expectation. However, it was thought that the service should only be on offer where at least one of the parties to the dispute was an ISDA member. One possibility would have been for the ISDA Board itself to take up any such issue, but it was thought that involving the full Board to consider every dispute and at every stage was impractical. Instead, consideration was given to the idea that a dispute would be referred to ISDA's Executive Director in the first instance, who in turn would refer the matter to a sub-committee of the Board. That smaller group of Board members would complete the bulk of the preparatory work for any dispute that was accepted for resolution.

Mechanics aside, the idea of the service had support among the ISDA Directors, not least because of the important message that it was hoped it would convey that ISDA was doing something responsible to reduce the potential for conflict or crisis in the markets. It was suggested that, in part to this end, the results of settled disputes be noticed in ISDA's newsletter[28] or otherwise be published.

Several Directors expressed willingness to serve as arbitrators. However, points of detail remained to be worked out. The approaches taken by one or more of the

27. The history that follows in this section of the article largely draws on the author's files and notes of contemporaneous and non-privileged discussions with members of ISDA's Board of Directors at a time when the author served as outside counsel to that Board.
28. It must be remembered that this was a discussion taking place at a time that pre-dates websites and emails!

exchanges that offered dispute settlement services were to be investigated, not least with a view to getting guidance on fees and the allocation of costs. And concerns about director liability in connection with the proposal still lingered. It was thought that outside counsel should be brought in to advise on the matter before any final decision on implementation was reached.

By January 1993, the search had started for a suitable market dispute that might test the procedures under consideration. That effort was being encouraged by concurrent consideration that was being given to settlement risk and disruption by a crisis management working group that ISDA had also created. It was thought that issues like these could easily ripen into market disputes and justified the attention being given to an ADR service dedicated to market practice issues. And again, it was also thought that the service under review would convey an important message to the regulators that ISDA was doing something responsible to reduce the potential for market conflict or crisis.

However, by the spring of 1993, consideration of a more formal dispute resolution mechanism for parties had given way to a more general proposal for a market practice advisory service, and this latter proposal was given wide circulation, including in materials distributed to ISDA members and attendees at ISDA conferences.

In turn, a Market Practice Advisory Service was reported out by ISDA's Board, complete with guidelines. Fees for issues brought were initially set at USD 1,000. However, this service does not appear to have ever acted in any formal way. Several fact patterns were discussed, and it was reported that live disputes had been promised. But agreed procedure called for a published result (without identifying the parties in the interest of confidentiality), and there does not appear to be any such result.

§2.06 THE PROGENY: SHARIA-COMPLIANT MASTER; ARBITRATION GUIDES; FRENCH AND IRISH LAW MASTERS; DETERMINATION COMMITTEES AND EXTERNAL REVIEWS; PROTOCOLS AND P.R.I.M.E. FINANCE

Nevertheless, the idea of the relevance of arbitration that inspired the just-described Board level discussions more than a quarter of a century ago has picked up again in the last decade. Indeed, ISDA's cutting edge support for ADR solutions has continued since publication and re-publication of the original ISDA Master itself. It can also be found outside the four corners of that ISDA Master form and the product-specific documentation that it incorporates.

[A] Islamic Finance

On 1 March 2010, ISDA, in collaboration with the International Islamic Financial Market (IIFM), announced the publication of its innovative ISDA/IIFM Tahawwut Master Agreement (the 'Islamic Finance Master'). Designed to advance trading relationships involving *Shari'a*-compliant hedging activity based on *murabaha* transactions, the Islamic Finance Master included, when benchmarked against the ISDA

Master, a number of new features. Though its form and structure are very much based on the 2002 Form, and a traditional jurisdiction clause providing for referral to English or New York courts is included, this appears as an alternative choice for the first time in ISDA standard form documentation since an arbitration alternative is also included. The parties can, if they so elect, provide for arbitration of their disputes under the ICC Rules or such other rules as may be specified by the parties in their schedule.

Enforcement was a key consideration in this case, in anticipation of certain jurisdictions in which the Islamic Finance Master was likely to be used. It was thought for that reason that arbitration may be advantageous in jurisdictions such as these where an arbitral award is perceived to be more easily recognized than would be a judgment from English or New York courts.

[B] The Arbitration Guides

Reference has already been made in this chapter to the two editions of the *ISDA Arbitration Guide,* which report evidence of growing interest in the possible broader relevance of arbitration to financial market disputes.[29] Publication of each Arbitration Guide followed an extensive consultation with ISDA members.[30]

As a result, the arbitration clause that first appeared in the Islamic Finance Master now keeps company with model clauses in the Arbitration Guides for use with the 2002 Form and the 1992 Forms for referrals to a menu of arbitral institutions (expanded to a dozen in the second edition of the Arbitration Guide[31]) and seats. The focus in the guidance provided was primarily on key reasons ISDA members had given for possible benefits of arbitration, including competence and enforcement.

[C] French and Irish Law ISDA Master Agreements

In contemplation of Brexit, ISDA published for the first time French and Irish law versions of the ISDA Master Agreement in July 2018. The move was 'intended to provide options for those institutions that would prefer to continue trading under a European Union (EU) member-state law with EU court jurisdiction clauses once the UK leaves the EU'.[32]

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29. *See supra* n. 2 and accompanying text.
30. Each followed also the circulation of memoranda outlining the issues and arguments supporting greater consideration of this form of ADR. A round-robin of meetings with ISDA members and other stakeholders in financial centres around the world preceded publication of the first edition of the Arbitration Guide, a series of conference calls preceded the second, and further comments were invited and received by ISDA staff in advance of publication of both. The surveys of views had demonstrated strong and growing market interest in arbitration and ADR and support for the Arbitration Guides and the guidance offered by them.
31. Including for the first time the Arbitration Institute of the Stockholm Chamber of Commerce.
32. ISDA Press Release, *ISDA Publishes French and Irish Law Master Agreements,* 3 July 2018 at https://www.isda.org/2018/07/03/isda-publishes-french-and-irish-law-master-agreements/ ('English law may become a third-country law after the UK withdraws from the EU, which means English court decisions would no longer be automatically recognized and enforced across the EU and European Economic Area (EEA). That wouldn't be the case for French or Irish law

Both forms are patterned on the 2002 Form of the ISDA Master, including the format of the more traditional jurisdiction clauses there, although interestingly the French law version, like the Islamic Finance Master, gives an arbitration option and contains a model clause in Part 4 of the form of its Schedule providing for arbitration under the ICC Rules with a seat in Paris. A model arbitration clause for use with the 2002 ISDA Master Agreement (Irish law), which provides for arbitration under the LCIA Rules with a seat in Dublin, was separately included in the second edition of ISDA's Arbitration Guide, which appeared around the same time.

[D] Credit Derivatives Determinations Committees and External Review

Perhaps the most striking embrace of ADR by ISDA and users of ISDA documentation can be seen in the Credit Derivatives Determinations Committees structure that makes binding contractual determinations for issues relating to credit default swaps.

Originally established by ISDA in 2009 but now independently administered,[33] the Determinations Committees are regional committees of experienced market participants, drawn from both the dealer and the non-dealer communities, tasked with comparing facts of specific events, based on publicly available information, with the provisions of standard credit derivatives contracts to make determinations regarding key provisions of those contracts. The Determinations Committees derive their authority from rules incorporated by ISDA documentation for credit derivatives (including those incorporating the ISDA Credit Derivatives Definitions).

The role that the Determinations Committees play is unique in the credit derivatives markets that they serve. Where there is a disputed interpretation, they make factual determinations of issues such as whether (i) a credit event meriting a pay-out under outstanding credit protection has occurred; (ii) whether an auction to determine the final price of any credit protection settlement should be held; and (iii) which reference entity obligations are eligible for delivery when physical settlement is contemplated.

The Determinations Committee process represents a form of ADR in itself. The challenge when one of the described decisions is presented to the relevant regional committee is for that decision to be made quickly and based on limited information in order to aid the efficient functioning of the market. The process is intentionally designed to ensure that trading conventions and commercial expectation are respected. However, the participating representative decision makers may have their own positions that will be impacted by the determinations they make, and part of the challenge is also to mitigate conflicts of interest. Not surprisingly, the results are closely watched and attract a great deal of attention in the media as well as in the markets themselves.

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court judgements under the new Master Agreements, reducing the steps involved in settling a contractual dispute with an EU/EEA counterparty.')

33. As of 9 October 2018, ISDA appointed DC Administration Services, Inc. as DC Secretary with responsibility for administering the governing rules. The website for the Determinations Committee can be found at the following URL: https://www.cdsdeterminationscommittees.org/.

Both the dealer and buy sides of the market are represented among the voting representatives on the committees. One way of seeking to ensure fairness and minimize conflicts of interest is to require supermajority votes (at least 80% of those participating) for key issues.[34] In situations where the requisite vote fails to be achieved, the question gets re-formulated as possible 'presented positions' and referred to an external review, another form of ADR, for a final and binding decision.

That has only happened four times in more than a decade that the Determinations Committees have been up and running.[35] External reviewers (usually independent legal experts, QCs, experienced market practitioners or academics) are selected from a panel. The process involves an expert determination by a panel of three external reviewers after arbitration-style arguments, with written submissions and a hearing all made public.[36] The decision deadline for the external reviewers is an extremely tight one: five business days after submission of the question for external review. As with all Determinations Committee decisions, the results of the external review process are published promptly[37] and bind all market participants whether or not they participated in the proceedings.

[E] Protocols

Reference should also be made to the development by ISDA of its revolutionary alternative 'pre-dispute' resolution (ApreDR) mechanism, the ISDA Protocols.[38] ISDA's

34. The 80% requirement ensures that a decision reflects support from *both* dealer and buy side representatives. For an early history of the Determinations Committees, *see* ISDA Press Release, *ISDA Paper Examines Three-Year History of the ISDA Credit Derivatives Determinations Committees,* 1 May 2012 at https://www.isda.org/2012/05/01/isda-paper-examines-three-year-history-of-the-isda-credit-derivatives-determinations-committees/.
35. The author has had the privilege of serving as an external reviewer on two of these occasions.
36. The decision-making process in an external review is a little complicated. If in the original vote of the Determinations Committee more than 60% of the voting members (but less than the 80% supermajority required) voted for a specific outcome, the question is decided in accordance with that majority vote unless the external reviewers unanimously conclude that another presented position is 'the better answer', in which case the question is decided by that decision of the external reviewers. If the original vote had been less than or equal to 60% of the voting members participating, the question is decided by that vote unless at least two out of the three external reviewers conclude that another presented position is 'the better answer', in which case the question is decided in accordance with the majority vote of the external reviewers.
37. Speed is of the essence. The markets need to know. At the last external review session in which I participated, the briefs in the matter were first filed on a Thursday, supplemental briefs on the Tuesday that followed, a hearing was held on the Wednesday, our decision (as it turned out our unanimous decision) announced later that same day – the markets had been trading and in effect 'betting' on the outcome in the course of the day – and we published that decision with seven pages of reasoning on the Friday. Litigation, on the other hand, can play out over years and involve fulsome discovery. Whenever a party enters into a credit default swap on ISDA terms, it is in effect putting its faith in the hands of the Determinations Committee procedures, which will ultimately decide whether or not a contested credit event that would require a pay-out has occurred – and that decision will bind the relevant market regardless of whether a court later decides in a dispute between private litigants that the Determinations Committee decision, or a follow on decision by external reviewers, was wrong.
38. ISDA's Protocol library can be found at: https://www.isda.org/protocols/.

Protocol project started as an exercise in crisis management in 1998 with the impending introduction of the euro and the resulting disappearance of eleven legacy currencies and related price sources and conventions.[39] It ended up heralding an unprecedented approach to international contract renegotiation and dispute resolution and avoidance taking advantage of what at the time of its first operation was ground-breaking use of the internet. Independent commentators have estimated that the successful promulgation of the original (European Monetary Union) EMU Protocol alone had potentially saved millions in negotiating time and reduced the risk of time-consuming and expensive litigation between swap counterparties. Indeed, a number of these commentators were of the view that, but for the Protocol, the necessary changes to derivatives contracts would not have been achieved in a timely fashion and litigation resulting from the introduction of the euro would have been rampant.

The first Protocol, which received awards and accolades at the time, has since become the model prototype for other Protocols used repeatedly since, and for multiple purposes, by the financial industry and its regulators.

[F] P.R.I.M.E. Finance

Although ISDA's own proposed arbitration facility (discussed at note 27 *supra* and the accompanying text) never operated, a number of those involved in the discussions at the time were instrumental in establishing an independent Panel of Recognised International Market Experts in Finance ('P.R.I.M.E. Finance') as a specialized institution formed for the specific purpose of facilitating the resolution of complex financial disputes, including by means of arbitration, mediation and other forms of ADR.[40]

Though not an ISDA project, P.R.I.M.E. Finance was set up in the wake of the 2008 global financial crisis with a mission to ensure that the best expertise was available for the settlement of complex market disputes and not least those relating to ISDA documentation and the considerable trading under it that the derivatives markets represent. P.R.I.M.E. Finance now comprises a panel of more than 200 pre-eminent lawyers, judges, bankers, regulators, academics and market participants with collectively more than 6,000 years of relevant experience. All are world leaders in the field of

39. Imagine that Party A and Party B had entered into a currency swap providing for the exchange of Deutschmarks for French francs at an exchange rate periodically set by a screen source, and the parties wake up the morning after the euro is introduced to find that neither legacy currency exists nor does any agreed future screen rate for fixing their exchange. Has their contract been commercially frustrated in a way that would permit one of the parties unilaterally to walk away from the trade? If not, what happens next? The Protocol, to which virtually all the major banks and financial institutions (and a great many others) had adhered, provided answers pursuant to a matching system of preferences, thereby settling the matter as between adhering parties and with the effect of removing most of the risk of litigation from the situation.

40. *See* the P.R.I.M.E. Finance website at: https://primefinancedisputes.org. P.R.I.M.E. Finance is housed at the Permanent Court of Arbitration in The Hague. ADR services, including arbitration, mediation and the provision of expert witnesses and expert opinions, determinations and risk assessment is a core activity and one of the three pillars upon which the project is based. The other two core activities are judicial training and the compilation of a central database of relevant financial market case materials and precedents.

finance or financial market dispute settlement and can provide effective and expeditious resolution of disputes as arbitrators, mediators or experts. Most draw on experience in particular of the ISDA world.[41]

The P.R.I.M.E. Finance project reflects recognition that specialist dispute resolution has a part to play as a complement to the more traditional role of courts – especially as matters in dispute between market participants get more technical and complex and the need for certain answers quickly achieved becomes greater. Formed against the backdrop of the last financial market crisis, the project also reflects a recognition that regulatory reform alone is not the best guarantee of global financial stability. Facts will change, and facts will always be important – they may also be unanticipated. When disputes happen as a result, possibly on a large scale, and speedy, authoritative and expert answers are required, ADR may be a particularly attractive option for reducing legal uncertainty.

§2.07 CONCLUSION

Despite considerable reliance on innovative and market-driven solutions for resolving actual and potential disputes in the derivatives markets, and the effectiveness of the mechanics employed for keeping such matters out of court, the role of ADR in the ISDA scheme of things has probably been underappreciated.

The evolution of the underlying methodology behind the concepts of Agreement Value, Market Quotation and Close-out Amount represents an ongoing attempt in the ISDA Master to achieve formulaic liquidated damages in order to limit the role of judges (and in New York court cases possibly the role of juries!) and, as an alternative, favour the role of market experts in order that often technical market issues can be determined for the markets by experienced market participants – and in a timely fashion.

Two commercial objectives were key in providing the inspiration for that approach: (i) mitigating the risk of costly and lengthy litigation and (ii) promoting certainty in the markets.

That has also led to an ever-broadening embrace of ADR techniques in the day-to-day operation of these markets in order to resolve or avoid disputes, and not just when assessing damages after default. Reference market makers and reference banks, calculation agents and valuation agents, Determinations Committees and external reviewers have all played their part.

Publication in the past decade by ISDA of Arbitration Guides with guidance, model arbitration clauses and new master agreements that expressly contemplate the possible election of arbitration has understandably attracted considerable attention and discussion. However, the role played by ADR in ISDA documentation and the derivatives market is more extensive than the place that arbitration alone plays, and

41. P.R.I.M.E. Finance experts include those who have previously served as Chair, CEO, General Counsel, director or officer, senior staff, outside or local counsel of ISDA and others who have participated in the ISDA working groups that have reported out ISDA documentation. All the external reviews of the Determinations Committee decisions have been decided by panels that included P.R.I.M.E. Finance experts.

the legacy of ADR and reliance by ISDA members on it similarly more established over a much longer period than is usually acknowledged. As this chapter has shown, mediation, conciliation, expert determinations and reliance on settlement through protocols are also contemplated by many relevant ISDA terms and practices, and each has contributed.

Perhaps not surprisingly, many ISDA 'alumni', seeped in this tradition, have been behind the drive for specialist ADR offerings like P.R.I.M.E. Finance. P.R.I.M.E. Finance was created against the backdrop of a prior global financial crisis and reflected a view that ADR had an important, if complementary, role to play alongside both the courts and global regulatory reform to ensure long-term financial market stability – and correct answers when complex financial disputes do arise!

Which may all be particularly telling at this moment in time. Writing as this author is amidst the COVID-19 pandemic, and with another potential financial crisis looming in its wake, there is mounting talk of a wave of resulting legal disputes[42] – claims of contractual frustration, force majeure, margin calls and valuation issues, practical issues arising from attempts to deliver notices or otherwise perform during lockdown, and close-out issues flowing from counterparty insolvencies to name just a few.

It can only be expected that ISDA and its membership will again seek cost-efficient and timely answers to the issues posed. Given the possible scale of the problem, it may also be expected that such an unprecedented challenge may require creative solutions.[43] On these facts and the brief record provided in this chapter there is every reason to expect that, as a result, the relationship between the ISDA world and ADR may expand, and so will its history.

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42. *See*, e.g., *Coronavirus Contract Disputes Start Hitting the Courts*, The Wall Street Journal (20 April 2020) at https://www.wsj.com/articles/coronavirus-contract-disputes-start-hitting-the-courts-11587375001; *Private Investors Prepare Legal Action to Recover Losses over Margin Calls*, Financial Times (7 April 2020) at https://www.ft.com/content/a64a1535-f518-4465-b67f-44b19aa97ff3.

43. Interestingly, a note from the UK Cabinet Office issued during the coronavirus crisis seems to invite a creative and extra-court approach to contract disputes arising out of the pandemic. *See Guidance on Responsible Contractual Behaviour in the Performance and Enforcement of Contracts Impacted by the Covid-19 Emergency*, U.K. Government Cabinet Office (7 May 2020) at [14]) at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/883737/_Covid-19_and_Responsible_Contractual_Behaviour__web_final___7_May_.pdf. ('Responsible and fair behaviour is strongly encouraged in performing and enforcing contracts where there has been a material impact from Covid-19. This includes being reasonable and proportionate in responding to performance issues and enforcing contracts (including dealing with any disputes), acting in a spirit of co-operation and aiming to achieve practical, just and equitable contractual outcomes having regard to the impact on the other party (or parties), the availability of financial resources, the protection of public health and the national interest.' *See also* a concept note issued by a group of eminent U.K. jurists, including two former Presidents of the U.K. Supreme Court, which calls for conciliation as a form of ADR in such situations, emphasises the possible benefits of a comparative law approach and suggests a search for outcomes which avoid leaving 'one party a winner, and the other party a loser'. *Breathing space – a Concept Note on the Effect of the Pandemic on Commercial Contracts*, British Institute on International and Comparative Law (7 April 2020) at https://www.biicl.org/breathing-space.