ISDA Publishes Guidelines For Smart Derivatives Contracts

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As technology develops, derivatives market participants continue to balance the digital transformations of their businesses with their need to manage risk. Such transformations present market participants with the challenge of integrating the benefits of technology, such as smart derivatives contracts (SDCs), with the lifecycle of derivative transactions, without disrupting the legal foundations on which such transactions are based.

In November 2018, the International Swaps and Derivatives Association, Inc. (ISDA), published a whitepaper, Smart Derivatives Contracts: From Concept to Construction, (Whitepaper) that sets out a framework for the use of SDCs for derivatives trading.1 Now, ISDA has continued its thought leadership by way of two new publications: Legal Guidelines for Smart Derivatives Contracts: Introduction (Introduction) and Legal Guidelines for Smart Derivatives Contracts: The ISDA Master Agreement (Master Agreement Guidelines, and together, the Guidelines). The Guidelines, as further described below, explain the core principles of ISDA documentation and their relation to SDCs and other derivatives trading technology.

Introduction

In the Introduction, ISDA provides high-level guidance on its documentary framework that governs derivatives trading and the potential application of SDCs with respect to the same. The Introduction touches on:

- an overview of ISDA documentation;
- defining SDCs;
- ISDA legal guidelines for SDCs;
- principles for the development of SDCs; and
- considerations for technology developers.

The Introduction provides readers with two key takeaways. First, the following four fundamental principles should underlie any effort to build SDC solutions:

- SDCs should be compatible with existing transactions;
- only parts of derivative contracts are capable of being automated;
- legal validation of SDCs is imperative to manage risk; and
- SDCs should only be implemented when sufficient benefits can be achieved.

Second, any SDC solution needs to contemplate the modular nature of the suite of ISDA documents. Ranging from the pre-printed Form of ISDA Master Agreement to confirmations, schedules and addendums, market participants routinely apply a combination of standard and bespoke documentation. It is therefore imperative that SDC solutions be flexible.

The Master Agreement Guidelines

In the Master Agreement Guidelines, ISDA builds on the Introduction, delving specifically into the application of SDCs to the ISDA Master Agreement. The Master Agreement Guidelines are structured into five core themes:

- events;
- close out and netting;
- contract formation and legal relations;
- disputes; and
- payments and deliveries.

The Master Agreement Guidelines go into detail, providing an overview and setting out considerations for technology developers, in connection with each of these subjects.

The theme underlying the Master Agreement Guidelines is that the management of rights and obligations under ISDA Master Agreements is complex and involves a degree of business judgment. Therefore, any effort to automate such processes (i.e. by way of SDCs) must account for this complexity and allow for the exercise of discretion.

For example, the right under Section 2(a)(iii) of the ISDA Master Agreement for a swap counterparty to suspend its payment obligations arises in respect of certain events of default. This right, however, is not automatic. Any effort to build this process into a SDC would need to (i) monitor for an event of default, (ii) recognize that the right is not automatic, (iii) account for the accrual of interest during the suspension of the payment obligations, (iv) provide for the resumption of payment if the event of default is resolved and (v) have its code be verifiable by market participants and their legal counsel.

Next Steps

Insofar as they highlight opportunities and challenges with respect to SDCs, the Whitepaper and the Guidelines are helpful preliminary resources for market participants undergoing or considering digital transformations. Firms should be encouraged by the process improvements that technology can bring to their operations. By proactively engaging counsel in connection with initiatives, such as the implementation of SDCs, firms can enjoy the benefits while mitigating downside legal, regulatory and compliance risks.

Contact Us

If you have any questions about SDCs, please contact one of the authors of this bulletin or any other member of BLG's Derivatives Group. BLG is ranked as the Number One Law Firm in Canada for Derivatives by Derivatives Weekly and has been named Canada Law Firm of the Year — Regulatory and Transactions — at GlobalCapital Americas Derivatives Awards every year since the inception of these awards.

[1] For a summary of the ISDA whitepaper, read our bulletin from November 2018.

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