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ТЕОРЕТИЧЕСКИЕ ИЗЫСКАНИЯ | THEORETICAL INQUIRIES

ISDA master agreement as a source of *lex mercatoria* in the international derivatives market

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Abstract

International financial markets play a vital role in the modern market economy. Among the instruments traded in these markets, derivative contracts are of particular interest. Over-the-counter derivatives are widely used to allocate risks pertaining to commercial activity. In contrast to many other commercial transactions, derivative products are documented based on model contracts produced by the professional community. The ISDA Master Agreement is by far the most influential of these. This framework contract is published by the International Swaps and Derivatives Association (hereinafter — ISDA), a private corporation established in 1985 to represent swap dealers and promote swaps contracts in general. Currently ISDA is a driving force behind the regulation of over-the-counter financial markets on a global scale. The prevailing use of its standard agreements may lead to the conclusion that ISDA documentation is a part of *lex mercatoria*, the a-national legal order not relying on any state law. Many scholars in the field of private international law tend to share this view. The article maintains that a connection to the laws of common law jurisdictions such as the state of New York and England and Wales is a strong argument against the status of ISDA agreements as transnational law. Apart from that it considers contractual self-help remedies, such as suspension of performance and close-out netting, as evidence of transnational and autonomous nature of ISDA documentation. Though their existence seems more convincing than the wide use of ISDA templates alone, these provisions are interpreted by national courts in reliance on the rules of applicable law. In the conclusion the author notes that, despite their importance in financial markets, the ISDA Master Agreements by no means operate as *contrat sans loi*. Therefore, they lack the degree of autonomy demonstrated by the UNIDROIT Principles of International Commercial Contracts and some of the International Chamber of Commerce (hereinafter — ICC) publications, and cannot be considered the sources of *lex mercatoria* in the strictest sense. However, given its enormous experience, the ISDA may, in future, draft a contractual instrument not connected to any national legal order. At present, in response to the need to update its standard documentation in the wake of the UK's exit from the European Union, ISDA has chosen to re-subordinate its 2002 model contracts to the laws of France and the Republic of Ireland, rather than publish contracts that are not governed by the law of any state.

Key words: derivative, financial market, derivative financial instrument, *lex mercatoria*, ISDA, transnational law, framework contract, standard documentation

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Генеральное соглашение ISDA как источник *lex mercatoria* на международном рынке деривативов

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Аннотация

Международные финансовые рынки выступают важной частью современной экономики. Среди многочисленных финансовых инструментов, обращающихся на этих рынках, выделяются деривативные контракты. Внебиржевые деривативы широко используются для распределения рисков, связанных с коммерческой деятельностью. В отличие от многих других коммерческих сделок, производные продукты документируются на основе типовых контрактов, самостоятельно составляемых профессиональным сообществом. Важнейший из таких контрактов — Генеральное соглашение ISDA. Этот рамочный контракт опубликован Международной ассоциацией свопов и деривативов ISDA — частной корпорацией, созданной в 1985 году для представления интересов своп-дилеров и для продвижения свопов в целом. ISDA в настоящее время является движущей силой регулирования внебиржевых финансовых рынков в глобальном масштабе. На основании превалирующего использования ее стандартных соглашений можно сделать вывод, что документация ISDA является частью современного *lex mercatoria*, наднационального правового порядка, не опирающегося на какую-либо национальную систему права. Многие ученые в области международного частного права склонны разделять эту точку зрения. В статье утверждается, что тесная связь с законами юрисдикций общего права, таких как штат Нью-Йорк и Англия и Уэльс, является весомым аргументом против статуса соглашений ISDA как источников транснационального права. Кроме того, в статье рассматриваются договорные средства правовой защиты, такие как приостановление исполнения и ликвидационный неттинг, как доказательство транснациональной и автономной природы документации ISDA. Хотя их наличие кажется более убедительным, чем широкое использование проформ ISDA, эти положения интерпретируются национальными судами с опорой на нормы государственного права. В заключение автор отмечает, что генеральные соглашения ISDA, несмотря на их важность на финансовых рынках, ни в коем случае не действуют как контракт «без закона» (*contrat sans loi*). Поэтому им не хватает той степени автономии, которую демонстрируют Принципы международных коммерческих контрактов УНИДРУА и некоторые публикации Международной торговой палаты (далее — МТП), и они не могут считаться источниками *lex mercatoria* в строгом смысле. Тем не менее, задействуя свой огромный опыт и репутацию на финансовом рынке, ISDA способна создать в будущем договорный инструмент, который бы не опирался ни на один национальный правопорядок. В настоящее же время, столкнувшись с необходимостью обновления стандартной документации на фоне выхода Соединенного Королевства из состава Европейского союза, ISDA предпочла переподчинить свои типовые договоры 2002 года праву Франции и Республики Ирландия вместо того, чтобы опубликовать договоры, не подчиненные праву какого-либо государства.

Ключевые слова: дериватив, финансовый рынок, производный финансовый инструмент, *lex mercatoria*, ISDA, трансграничное право, рамочное соглашение, стандартная документация

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Introduction

In recent decades, derivative products such as swaps, options, forwards and futures have become a critical component of the modern market economy. They get a lot of praise for risk distribution opportunities allowing financial institutions, governments and corporations to hedge their existing exposures. However, the reputation derivatives currently have is somewhat controversial. Following a massive financial crisis that erupted in 2007, privately negotiated derivative contracts, especially credit default swaps, gained unprecedented attention and became a subject of vigorous scholarly research. According to the view widely shared in scientific and business communities, one of the reasons behind the crisis was a lack of regulation in the derivatives market. Following the G20 Pittsburgh summit in 2009, sovereign states implemented regulatory reforms to address the systematic risks associated with derivatives. This resulted in stricter rules governing the financial sector. In this new reality, traders in derivatives as well as their clients have to deal with the regulatory burden. They often need to report their derivative transactions, submit their contracts for central clearing via central counterparties, and make additional margin transfers to reduce counterparty risk.

Despite the importance of regulatory aspects, issues of international private law relating to cross-border derivative products still remain relevant. Privately negotiated derivatives have relied on standard contracts published by industry associations. Wide use of model contractual templates allows market participants to save time, minimise transactional costs, and increase the predictability of their contractual relationships. This publication attempts to ascertain whether the ISDA Master Agreement, the most popular standard contract used in the derivatives market, may be considered a full-fledged source of modern *lex mercatoria*, or the new law merchant.

According to this concept, the commercial community is capable of creating the third legal order in addition to international public law and the laws of sovereign states. Since its inception in the middle of the XX century, the theory of the new *lex mercatoria* has sparked a wide debate among international lawyers. The scope and sources of the *lex mercatoria* remain unclear to this day. Nevertheless, within the present article, we shall treat it as an autonomous system of rules not connected to a governing law of any state. In addition to the *lex mercatoria* we will also refer to "*transnational commercial law*" and "*law merchant*". Although these concepts may have different meanings in the legal doctrine, here we treat them as synonyms. Sometimes we will use the terms the "new law merchant" or the "new *lex mercatoria*" to distinguish the reinvented *lex mercatoria* from the "old" law merchant.

The first part of this article introduces the general concept of *lex mercatoria*. It refers to the founding fathers of the new law merchant and makes a particular emphasis on international commercial arbitration as the main method of dispute resolution associated with the concept. On top of that, it summarises the views of international scholars advocating the transnational status of the ISDA Master Agreement. As this model contract provides a legal framework for derivatives — sophisticated financial instruments generally unknown to the wider public — the author gives some introductory information on derivatives in the second part of this publication. The third part sheds light on the ISDA Master Agreement itself. It highlights the structure of this model contract, provides some historical information as well as describing other elements of the ISDA standard documentation, in particular the ISDA definitional booklets. The final section of the present publication contains a critical analysis of the *lex mercatoria* concept in connection with the ISDA Master Agreement as its source. The conclusion outlines the results of the present research.

1. *Lex mercatoria* as a transnational legal order

Lex mercatoria initially emerged in Europe in the Middle Ages as an autonomous body of commercial law, consisting of trade customs and practices. At the time, merchants managed to establish the rules governing their commercial behavior and resolve disputes associated with international commercial transactions based on these autonomous rules. In England, the jurors of these courts were represented by foreign and local merchants, which incentivised merchants from abroad to submit their mercantile disputes to English commercial courts (Goode &McKendrick, 2010, p. 4).

The first doctrinal text on the subject was published by G. Malynes, an English merchant and tradesman. Having served as a commissioner of trade in the Low Countries and frequently advised the Privy Council on the matters of international commerce, Malynes was well acquainted with the rules of international trade. He defined *lex mercatoria* as the customary law of the merchants built upon the foundations of Reason and Justice (Malynes, 1622).[1]

In the 1960s, B. Goldman and C. Schmithoff, the fathers of the new *lex mercatoria*, revisited the concept. According to their views, the contemporary business community is able to regulate itself based on a-national rules, mostly in the same manner as their predecessors in Medieval Europe did. K. P. Berger, a German legal scholar and arbitrator, argues that the list of the founding fathers of transnational mercantile law is not limited to B. Goldman and C. Schmithoff, but also includes other European scholars, such as C. Fragistas, A. Goldstajn, P. Kahn, and P. Fouchard (Berger, 1999, p. 1–2).

The gradual recognition of the existence of the new law merchant in contemporary context has been described as “one of the most remarkable developments in international commercial law over the last fifty years” (Cuniberti, 2013, p. 369). The whole concept of the new *lex mercatoria* is closely related to the alternative resolution of international commercial disputes through arbitration. Notwithstanding the fact that arbitration has a long history, legal scholarship still lacks a universally accepted definition of that phenomenon (Ferrari & Rosenfeld, 2021, p. 1). Generally, arbitration is a private mode of resolving disputes and controversies based on the mutual agreement of the parties involved. In recent decades, international commercial

1 Available at: https://quod.lib.umich.edu/e/eebo/A06786.0001.001/1:5?rgn=div1;view=fulltext.

arbitration has become the preferred way of adjudication in cross-border trade due to numerous advantages it has over litigation in state courts. Among those advantages is the ability of the arbitral tribunal to resolve a case based on a-national rules rather than national laws.

E. Gaillard, a prominent international arbitrator and co-author of the renowned treatise on the subject (Fouchard, Gaillard, & Goldman, 1996), examined *lex mercatoria* through the lens of international commercial arbitration. He noted that specialists in the field of arbitration almost unanimously recognise the existence of *lex mercatoria* within their domain. Such recognition should not come as a surprise since reliance on informal sources of law generally contributes to the attractiveness of international commercial arbitration. Nevertheless, they said, there is still some room for debate among those who, in theory, should strongly support the existence of an autonomous legal order in the field of international commerce. According to Gaillard, the very heart of the debate over *lex mercatoria* gradually shifted from the mere existence of transnational commercial law to its scope and methodology (Gaillard, 2001, p. 59–60).

The views on the new merchant vary outside the alternative dispute resolution community. V. Kanashevskiy, a prominent Russian researcher in the field of private international law, argues that three views on the concept of *lex mercatoria* are featured in contemporary scientific debate. The first, and the most radical, view is that the new law merchant is an autonomous legal system different from national laws and existing independently of them. The second view is that *lex mercatoria* in the modern age is merely a set of rules sufficient to resolve international commercial disputes. Accordingly, the new law merchant serves as an alternative to national laws when resolving a particular case, which otherwise would have been applicable. The third view is minimalistic as it denies *lex mercatoria* as a self-sufficient legal system. Its supporters maintain that *lex mercatoria* is simply a codification of customs existing in international trade (Kanashevskiy, 2019, p. 393). Those customs are recognised by sovereign states and are often applied by judges in commercial courts of those states. They enjoy the status of the sources of domestic law, alongside statutes, case law, and international treaties.

Another important issue to decide is where one can find the rules of *lex mercatoria*. Naturally, adjudicating legal disputes between international businessmen should rely on some kind of authority. K. P. Berger claims that we are witnessing the creeping codification of the new *lex mercatoria*. Therefore, *lex mercatoria* has already reached an advanced stage in its development. Codification agents, mainly international organisations focusing on the law of international trade, play a leading role in this process. For instance, the

International Institute for the Unification of Private Law (hereinafter — UNIDROIT) has published the UNIDROIT Principles of International Commercial Contracts.[2] According to their preamble, this set of legal principles may be used as the governing law of an international commercial contract whenever the parties refer to *lex mercatoria*, general principles of law or use analogous contractual language. Another codification agent is the United Nations Commission on International Trade Law (hereinafter — UNCITRAL). Its mandate includes the progressive harmonisation and modernisation of the law of international trade. Within its mandate, UNCITRAL develops and promotes non-legislative instruments alongside international treaties in various areas of commercial law. ICC is yet another example of a codification agent in the domain of international trade. Being one of the largest business organisations in the world, ICC publishes rules and guidelines for international lawyers, arbitrators, bankers and traders. Its best-known publications include Uniform Customs and Practice for Documentary Credits, Incoterms and the Uniform Rules for Demand Guarantees.

Notably, B. Goldman and C. Schmithoff, whose legacy remains authoritative, also focused on the activities of private international trade associations in their attempts to identify the sources of the new *lex mercatoria*. Goldman, a French legal scholar and the founder of the Dijon School, gave one of them credit for shaping the laws of international trade. In his groundbreaking article of 1964 (Goldman, 1964), he dwelled upon the work of the London Corn Trade Association. Schmithoff, a German-born scholar turned English barrister, emphasised the importance of model contracts and adhesion rules in international commercial relations. According to Schmithoff's view, a model contract form "is a specimen form to which the lawyer or businessmen will turn when charged with the duty of drafting a contract and which will be altered and adapted to meet the situation at hand" (Schmithoff, 1968, p. 551). Alongside mentioning the London Corn Trade Association, as Goldman did, he also referred to the standard documentation of the Association of Corn Merchants of Hamburg, the Bremen Cotton Exchange, the Silk Association of America and the International Wool Textile Organisation.

Although ISDA was established in the 1980s and rose to prominence in the 1990s, it seems logical that the founding fathers of the new law merchant would have included the ISDA Master Agreement in their list of the sources of *lex mercatoria*. Within contemporary financial markets, the ISDA plays a role, similar to the one demonstrated by the trade associations in corn, cotton, and textile industries, which attracted the attention of Schmithoff and Goldman.

[2] UNIDROIT (2016) Principles of International Commercial Contracts. URL: https://www.unidroit.org/wp-content/uploads/2021/06/Unidroit-Principles-2016-English-bl.pdf.

While adjudicating a case in an English court related to the insolvency of Lehman Brothers investment bank, Judge Briggs noted that the ISDA Master Agreement governed the majority of derivative contracts on a global scale.[3] This view is supported by several legal scholars in the field of financial markets (Charles, 2009, p. 14–15).

More importantly, the significance of the ISDA Master Agreement in the world of international finance is not limited to its wide use. In particular, Berger praised the ISDA for its efforts in creating legal rules. He notes that the ISDA's work is comparable to the efforts undertaken by UNCITRAL, UNIDROIT and the Hague Conference on Private International Law (Berger, 2010, p. 44). When discussing the existence of *lex mercatoria* in international financial markets, the Center for Transnational Law (hereinafter — CENTRAL) pinpoints to the ISDA as well as the ICC and the Loan Market Association (hereinafter — LMA).[4] According to CENTRAL, uniform rules of a private nature drafted by the ISDA, the ICC and the LMA dominate the field of international banking and finance.

M. Borowicz treats the ISDA Master Agreement as a regulatory contract. The principal feature of such instruments is that they limit the ability of their users to deviate from contractual terms (Borowicz, 2021, p. 72, 81). Thus, the ISDA Master Agreement resembles the legal rules imposed by sovereign states. J. Braithwaite notes that the transnational status of the ISDA documentation is widely accepted in the literature on international private law (Braithwaite, 2020, p. 308). Another supporter of the autonomous status of ISDA documentation is J. H. Dalhuisen, a Dutch scholar and prominent researcher in the field of transnational commercial law, as well as the author of a six-volume treatise on the subject. In line with Dalhuisen's views, professional institutions dealing with international commercial and financial transactions are capable of developing substantive transnational law when these commercial operations are concerned. This substantive law constitutes non-territorial, non-statist legal order, and ISDA acts as a law-maker for international swaps markets within this order (Dalhuisen, 2013, p. 354).

Therefore, the concept of *lex mercatoria* and its scope is a matter of ongoing dispute. The variety of views on its sources is really great. However, in our view, the whole concept makes sense when seen as an autonomous regulator of international trade and commerce, operating on top of other sources of law. Otherwise, it would be extremely complicated to draw the line between national laws and sources of *lex mercatoria*. Transnational commercial law requires much autonomy, and the addition of the ISDA to its rules should be subject to its autonomous nature, similar to that shown by the UNIDROIT

3 Lomas v JFB Firth Rixson [2011] 2 B.C.L.C.120.

4 See: https://arbinfinanz.uni-koeln.de/lex-mercatoria_ID13.

Principles. To find an answer, we must shed some light on the ISDA and its operations.

2. Derivatives markets and the rise of ISDA as the leading derivatives industry association

The ISDA is a professional association operating in derivatives markets. Hence, before discussing the status of the ISDA Master Agreement in relation to the new law merchant, it is sensible to focus on the legal features of derivatives. According to the statistics maintained by the Bank for International Settlements, the nominal value of interest rate and foreign exchange derivatives exceeds 18 billion US dollars.[5] The current size of the derivatives market exceeds the annual gross domestic product. Unsurprisingly, these financial instruments have a significant impact on the world economy.

Nowadays these instruments are in high demand by the actors involved in international trade, as they allow importers, exporters and multinational corporations to manage the risks associated with their commercial operations (Kolb & Overdahl, 2003, p. 69). Despite their innovative character and reliance on modern technology, derivatives have quite a long history. For instance, futures trading took place in the XVI century when contracts for the sale of rice and tulips traded on exchanges in Japan and Holland (James, 1999, p. 1). Moreover, some say that the simplest forms of derivatives date back to antiquity (Benjamin, 2007, p. 64). Thales, a Greek philosopher, is viewed as the first option trader.[6]

Trading in derivatives has grown dramatically in the second half of the XX century, following the collapse of the Bretton Woods international currency system (Benzler, 1999, p. 31n13). Another important factor in the development of the derivatives industry was the progress made by financial scientists. They proposed a mathematical model for valuation of options that was widely adopted by banks and other financial institutions. Currently, derivatives form a wide variety of contractual instruments. Apart from deliverable contracts involving fungible goods, securities and foreign currencies, derivatives are represented by numerous contracts that are settled exclusively in cash. Cash settlement allows the parties to tie contractual performance to virtually any asset, rate or event. Moreover, some authors argue that contracts with physical settlement should not be considered derivatives. Proponents of the view include S. James, whose note that commodity contracts should not be normally viewed

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[5] See OTC derivatives statistics: https://data.bis.org/topics/OTC_DER/tables-and- dashboards/BIS,DER_D5_1,1.0.

[6] Foulke, D. (29 November 2013) Thales–The World's First Option Trader? *Alphaarchitec*. URL: https://alphaarchitect.com/2013/11/9491/.

as derivatives (James, 1999, p.3n21). Another supporter of this attitude is G. Reiner, a German legal scholar (Reiner, 2002, p. 14).

Although derivatives have been around for quite some time, it may prove problematic to formulate a generic definition that encompasses all types of derivatives (Kolb & Overdahl, 2003, p. 1n20). The terminological confusion surrounding derivatives may prevent regulators from understanding their legal nature, thus creating loopholes in their legal treatment. M. Armitage views them as “private, bilateral arrangements between counterparties trading financial instruments such as forwards, options swaps or combinations of the aforementioned” (Armitage, 2022, p. 317, 322). According to J. Benjamin, derivatives are bilateral contracts whereby the rights and duties of the parties are tied to a specific asset class, or benchmark and where performance takes place at a remote date. German scholar M. Benzler describes them as bilateral (*zweiseitige*) transactions with performance depending on the occurrence of a certain future event (Benzler, 1999, p. 29n13).

Thus, derivatives have three key features. Firstly, they take the form of bilateral commercial contracts. According to the alternative view, in addition to contractual instruments, derivatives may exist in the form of fungible securities (Gaudemet, 2016, p. 49, 51). However, this view is not shared by the majority of scholars in the field of international financial markets. Financial regulators and the courts in most cases do not treat derivatives as securities in the legal sense of this word. Having said that, we will also consider derivatives as commercial contracts mostly containing a promise by a party to pay a certain amount of money to its counterparty. The second unique feature of derivatives is their dependence on the value of another asset, such as an index, a security, a commodity or foreign currency. Finally, the performance of a derivative contract usually takes place at a later date than the date of its conclusion. According to J. Braithwaite, when these instruments are used by pension funds, the tenure of the instrument may amount to 20 years (Braithwaite, 2020, p. 15n17).

Depending on the place of performance, derivative contracts fall into one of the two categories: on-exchange agreements and privately negotiated contracts concluded over-the-counter without the involvement of an exchange as a coordinating authority. The simplest type of over-the-counter derivatives contract, the deliverable forward, envisages the delivery of a security, cash in a certain currency or a commodity at a certain pre-agreed date. Non-deliverable forward is more complex as the parties thereto should settle in cash depending on the underlying asset price at the delivery date. Futures are very similar to forwards, although futures trading takes place exclusively on organised markets. Options are derivative contracts with asymmetric risk structure and may be traded on or off exchange. An option buyer usually assumes the right, but not the obligation, to buy or sell a certain asset in exchange for a premium. Thus, under an option agreement, the risk of loss that may be potentially incurred by an option buyer is limited to the amount of premiums paid to the option seller.

The introduction of a swap contract was an important innovation in the world of derivatives, resulting in the emergence of the ISDA as the leading industry association. A swap is a financial contract envisaging an exchange of payments linked to currency and interest rates. The ISDA was established amidst the rapid development of currency and interest rate swap trading. The first reported swap contract was entered into by the World Bank and the IBM corporation in 1981.[7] The former needed Swiss francs and Deutschmarks to finance development projects in emerging markets, while IBM wished to raise debt in those currencies. The interaction between the parties led to the conclusion of the first cross-border currency swap agreement.[8] This deal was structured by Salomon Brothers Investment Bank, one of the founders of the ISDA.

The main reason for establishing this industry association in 1985 was the lack of standard contracts in the swaps market. According to Armitage, a "battle of the forms" took place between a group of swap dealers (Armitage, 2022, p. 321n28). Hence, promulgating standard documentation for the markets would have allowed them to spend less time on negotiation and bring the market practice to a common denominator. The ISDA founding banks retained two law firms — Allen and Overy in London and Cravath in New York — to advise on how to proceed (Borowicz, 2015, p. 46, 50). The first ISDA contractual instrument addressing concerns over swaps appeared the same year.[9] Although initially ISDA operations were limited to swaps, in the course of time they encompassed all kinds of over-the-counter derivatives (Benjamin, 2007, p. 64n22). Over the years, the ISDA has demonstrated the ability to adapt to rapidly changing consequences in the vibrant field of international financial markets. Its current activities are very diverse. In addition to drafting and updating numerous contractual instruments, the ISDA has authored and promoted a model netting act addressing various issues related to early

7 When Was the First Swap Agreement and Why Were Swaps Created? (13 October 2022) *Investopedia*. URL: https://www.investopedia.com/ask/answers/051115/when-was-first-swap-agreement-and-why-were-swaps-created.asp.

8 Pioneering new ways to raise funds, the World Bank's Treasury entered into the world's first formal currency swap agreement in 1981, with U.S. technology giant IBM as its counterpart. See: https://thedocs.worldbank.org/en/doc/981111541019927135-0340022018/original/70yearschapterfour.pdf.

9 ISDA (1985) Code of Standard Wording, Assumptions, and Provisions for Swaps. URL: https://www.rbccm.com/assets/rbccm/docs/legal/doddfrank/Documents/ISDALibrary/1985%20Code%20of%20Standard%20Wording%20-%20Assumptions%20and%20Provisions%20for%20Swaps.pdf.

termination of derivative trades, and shared legal opinions related to its enforceability with its members (Datoo, Williams, & Whiteley, 2023, p. 260).

Its rule-making efforts were highly successful as insolvency laws in dozens of jurisdictions were amended to implement ISDA's view on how insolvency practitioners and bankruptcy courts should treat claims under financial contracts. 2018 Model Netting Act,[10] the most recent soft law instrument of this association, adopted a balanced approach to close-out netting, the core element of ISDA standard documentation. To be successful in that type of work, the ISDA maintains ongoing dialogue with the international organisations, regulators and legislators around the world. Its members benefited from ISDA lobbying efforts and flexible approach to interaction with governmental authorities both in developed and emerging markets. In addition to its legislative efforts, the ISDA prepares *amicus curiae memoranda* to share its views on how ISDA documentation should be applied and interpreted in court proceedings around the world.

3. A closer look at the ISDA Master Agreement

Following a brief introduction to the topic of derivatives and some information on the establishment of ISDA, we shall move to the ISDA Master Agreement (hereinafter — ISDA MA), ISDA's most notable achievement (Muscat, 2009, p. 32, 36) and a potential source of the new law merchant in international financial markets. 1987 was a year when the ISDA unveiled its first standard framework contract: the 1987 ISDA Interest Rate and Currency Exchange Agreement.[11] Although this contractual instrument is not in demand by the participants of financial markets (Muscat, 2009, p. 36n41), it can nevertheless be viewed as an important milestone in the development of over-the-counter derivatives trading. The next framework agreement, published in 1992[12] (hereinafter — 1992 ISDA MA), covered more than just interest rate and currency exchange derivatives. It encompassed the whole variety of financial instruments already existing in the derivatives markets at the time and also created a legal framework for financial innovation that entered the market in the 1990s — the credit default swap. The 1992 ISDA MA was published in two versions. The first one targeted the local market and envisaged over-the-counter transactions between the parties established in the same

[10] ISDA (2018) Model Netting Act and Guide. URL: https://www.isda.org/book/2018-model-netting-act-and-guide/.

[11] ISDA (1987) Interest Rate and Currency Exchange Agreement. URL: https://www.isda.org/book/1987-interest-rate-and-currency-exchange-agreement/.

[12] ISDA (1992) Master Agreement (Local Currency – Single Jurisdiction). URL: https://www.isda.org/book/1992-isda-master-agreement-local-currency/.

jurisdiction. To the contrary, the second version of the 1992 ISDA MA contained contractual provisions that took into account the cross-border nature of derivative transactions. As the financial market is truly global, the cross-border version of the 1992 ISDA MA reflected its international nature and facilitated trading in derivatives between parties in developed and emerging markets.

Following the 1998 financial crisis, the ISDA recognised the necessity to amend its framework contract. Four years later, the association published the 2002 ISDA MA.[13] This framework agreement remains a common legal standard for derivatives industry until the present day. Unlike the 1992 ISDA MA, this boilerplate contract may be used for both domestic and cross-border dealing in derivatives. Arguably, the most important innovation introduced by the 2002 ISDA MA in comparison to the 1992 ISDA MA was the new approach to close-out netting, which is the core element of the ISDA standard documentation and a popular risk mitigation tool in financial markets. Apart from the new approach to close-out netting itself, the ISDA added a force majeure event to the list of termination events, entitling the parties to the framework contract to terminate it and close-out affected transactions in presence of a force majeure or act of state making performance impossible or impracticable.

Both the 1992 and the 2002 ISDA MAs set out a similar mode of interaction between the parties in the over-the-counter derivatives market. The framework agreement establishes the procedure for concluding and executing individual transactions, determines jurisdiction and applicable law, contains representations and warranties, and regulates the procedure for terminating transactions. The ISDA standard agreements are praised for their flexibility in negotiating and concluding derivative trades. They envisage entering into separate transactions through negotiations over the phone with subsequent exchange of formal confirmations.[14] Confirmations are relatively laconic documents outlining commercial terms of derivative trades. Absence of a confirmation does not invalidate a trade *per se*. What is more, confirmations often contain a reference to standard definitional booklets setting out standard terms of particular transactions. For instance, the definitions for currency conversion transactions feature mutual rights and obligations to transactions involving currency forwards and options.[15] Parties to them shall deliver foreign currency in line with their mutual agreements. The ISDA definitions relating to interest rate derivatives cover a wide range of instruments including interest rate

[13] ISDA (1992) Master Agreement (Multicurrency – Cross Border). URL: https://www.isda.org/book/1992-isda-master-agreement-multi-currency/.

[14] Section 8(e)(ii) 2002 ISDA MA.

[15] ISDA (1998) ISDA FX and Currency Option Definitions. URL: https://www.rbccm.com/assets/rbccm/docs/legal/doddfrank/Documents/ISDALibrary/1998%20FX%20and%20Currncy%20Option%20Definitions.pdf.

swaps, cross-currency swaps, caps, floors, and collars.[16] Parties entering into relevant transactions would exchange payments depending on interest rate fluctuations. The ISDA Dentitions for Credit Derivatives address contractual issues related to credit default swaps and other similar instruments tied to credit events. Under a credit default swap, or a CDS, one party provides access to credit protection payable in exchange for a premium whenever there is a default under a reference asset.

In practice, users of the ISDA MA are very diverse. Usually, they fall into one of the two major groups: sell-side and buy-side counterparties. Sell-side parties are represented by financial institutions such as commercial banks, investment firms, clearing houses and other financial institutions. They market derivatives among a wide range of clients who act as end users of derivative products. According to J. Braithwaite, most derivative trades are originated by two dozen of leading global banks (Braithwaite, 2020, p. 15n17). As the case law shows,[17] such banks include leading financial institutions from a variety of countries, primarily based in the west (e.g. BNP Paribas, Standard Chartered Bank, Credit Suisse International). Another example of a sell-side counterparty in the derivatives market is Lehman Brothers, a leading investment bank established in the United States. Its collapse resulted in the largest insolvency case in US history and the closing out of countless derivatives transactions. In the course of insolvency proceedings commencing on 15 September 2008 at the request of the debtor (Charles, 2009, p. 16n13), the number of derivative trades based on standard contracts exceeded 733 000 (McNamara & Metrick, 2019, p. 143). What is more, the Lehman collapse contributed significantly to derivatives-related case law.[18]

Although the ISDA is headquartered in New York, it has representative offices in other financial centres. Since its inception, the ISDA MA has demonstrated its truly international status. In a cross-border context, the ISDA MA is in demand by private counterparties in multiple jurisdictions. There is evidence of its use by the parties from Russia, Indonesia, the United Kingdom, Germany, Spain, Italy and many other countries. Apart from that, the ISDA MA governs contractual relations between municipal entities[19] and separate

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16 ISDA (2006) ISDA Definitions. URL: https://www.rbccm.com/assets/rbccm/docs/legal/doddfrank/Documents/ISDALibrary/2006%20ISDA%20Definitions.pdf.

17 BNP Paribas v. Wockhardt EU Operations (Swiss) AG [2009] EWHC 3116 (Comm); Standard Chartered Bank v. Ceylon Petroleum Corp; Credit Suisse International v Stichting Vestia Groep [2014] EWHC 3103 (Comm).

18 Lehman Brothers Holdings, Inc., Case No. 08-13555 et seq. (JMP) (jointly administered); Lehman Brothers Special Financing Inc v National Power Corporation and another [2018] EWHC 487 (Comm).

19 Hazell v Hammersmith and Fulham LBC [1992] 2 AC 1, Kleinwort Benson v. Glasgow City Council [1997] 4 All E.R. 641. Westdeutsche Landesbank v. Islington [1996] A.C. 669. JP Morgan v.

states.[20] The financial world is proud of its standard agreement, which survived enormous pressure amidst the biggest financial crisis since the Great Depression (Paech, 2016, p. 855). Another crucial achievement of the ISDA MA is its influence on contractual practices adopted by domestic professional associations in the field of over-the-counter derivatives. Through collaboration with local professional associations, the ISDA shaped many other domestic agreements for over-the-counter financial transactions.[21]

4. The ISDA Master Agreement as a source of the new *lex mercatoria*: a critical approach

The rationale behind the ISDA's status as a non-state rule maker in the international financial markets is quite clear. Firstly, its framework agreement was created by a professional community rather than of a sovereign state or an international organisation. The ISDA was established by leading swap dealers — namely, multinational banking institutions involved in derivatives trading across multiple jurisdictions. According to the ISDA by-laws, the organisation is incorporated as a non-profit corporation.[22] Therefore, it has a private status, and its contractual instruments have a non-state nature. Secondly, the ISDA MA obviously is in high demand among the members of the professional community. Whenever two companies have the need to trade derivatives off-exchange, they would most commonly enter into an agreement produced by the ISDA (Hull, 2022, p. 55).

However, in our opinion, the private nature and the wide use of the ISDA documentation are not enough for the ISDA framework contract to become a part of the *new mercatoria* in its strictest sense. To shape transnational commercial law in the international financial markets, one has to exclude the application of national law to those contractual documents that are considered to be the building bricks of *lex mercatoria* of the financial industry. Thus, the ISDA's contribution to the development of *lex mercatoria* depends on its capacity to challenge national law while creating and promoting its standard contracts by introducing a *contrat sans loi.* Notably, to do so would mean that the ISDA is eager to undermine the established market practice, as all other similar cross-border master agreements feature governing law clauses.

Berliner Verkehrsbetriebe (BVG) Anstalt des Offentlichen Rechts [2010] EWCA Civ 390; Dexia Crediop S.P.A. v. Comune di Prato [2017] EWCA Civ 428.

[20] State of the Netherlands v. Deutsche Bank AG [2019] EWCA Civ 771.

[21] Derivatives Regulation in Russia. URL: https://en.nplaw.ru/blog/detail/derivatives-regulation-in-russia/.

[22] ISDA (2019) By-Laws of International Swaps and Derivatives Association. URL: https://www.isda.org/a/u0SME/ISDA-By-Laws-April-11-2019.pdf.

The existence of governing law provisions and reliance on state law in general is widely spread in international financial markets. For instance, the boilerplate contracts of the Foreign Exchange Committee — an organisation comprising the members of the banking community and representatives of some other financial institutions — encourage the parties to its documentation to choose between the laws of New York, the laws of England and Wales, and the laws of Japan.[23] When publishing a master agreement for cross-border derivatives, the National Association of Institutional Investors in Financial Markets — the leading industry organisation in the People's Republic of China — included a governing law clause to its standard framework contract as well.[24]

In an effort to create a competitor for the ISDA MA, the European Banking Federation (hereinafter — EBF) promulgated a multi-product framework agreement for a whole range of financial transactions including derivatives.[25] Unlike the contracts of the Foreign Exchange Committee, it may be governed by the law of any EBF member state. The Global Master Repurchase Agreement (hereinafter — GMRA),[26] is a model contract designed for parties dealing in repos features a governing law clause. The same is true of the Global Master Securities Lending Agreement (hereinafter — GMSLA),[27] a contractual instrument establishing a transnational legal framework for securities lending transactions. GMRA and GMSLA are quite similar to each other in terms of contents and governing law, as the laws of England and Wales apply to both standard contracts.

Similarly, the ISDA MAs are governed by the laws of New York and English law. One of the most powerful arguments against the a-national nature of the ISDA MA is its reliance on state law as the governing law of contract. Indeed, almost all cross-border model contracts in the financial industry contain a governing law clause, and the ISDA MA is by no means an exception. T. Kindt views the ICC and ISDA as organisations establishing a cross-border contractual law regimes (*transnationalen Vertragsrechtsregime)* for the relevant commercial transactions (Kindt, 2023, p. 304). However, the ISDA's approach

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23 See: FXC Master Agreements. URL: https://www.newyorkfed.org/fmlg/documentation/master.html.

24 See: NAFMII Master Agreement (Cross Border–2022 Version). URL: https://www.nafmii.org.cn/ggtz/gg/202208/P020220831632138066172.pdf.

25 See: The Master Agreement for Financial Transactions. URL: https://www.ebf.eu/home/european-master-agreement-ema/.

26 See: Global Master Repurchase Agreement (GMRA), ICMA. URL: https://www.icmagroup.org/market-practice-and-regulatory-policy/repo-and-collateral-markets/legal-documentation/global-master-repurchase-agreement-gmra/.

27 GMSLA Title Transfer – International Securities Lending Association (ISLA). URL: https://www.islaemea.org/gmsla-title-transfer/.

to the transnationality of its contractual documents is in stark contrast to the one adopted by the ICC or UNIDROIT.

The ISDA has never treated its model documents as a way to set aside national laws. Instead of opting out of the application of any governing law, either explicitly or by virtue of conflict-of-laws rules, it embraced state laws through a governing law clause present in each and every standard contract it drafted. According to the 2002 ISDA MA guide authored by the association itself, the users of its documentation should carefully consider all possible options before choosing an alternative governing law, let alone opt for the absence of the applicable law clause.[28] Moreover, several years ago, the association published another guide, this time addressing the choice of court and governing law provisions of the ISDA MA.[29] The drafting changes within the document relating to governing law clauses are solely to clarify matters for parties that have selected English law or New York law as the governing law.

In light of the withdrawal of the United Kingdom from the European Union on 31 January 2020, the ISDA could have produced a boilerplate contract that is not governed by any national law. However, the association preferred the laws of other states rather than making the ISDA agreement a true *contrat sans loi*. Faced with uncertainties presented by Brexit, it opted for the publication of amended versions of the 2002 ISDA MA governed by French[30] and Irish law.[31] When preparing those agreements, the ISDA was primarily concerned with the fact that the common legal framework for the recognition and enforcement of court decisions made in the European Union would no longer be available in the United Kingdom.

Berger notes that the ISDA makes efforts to move itself away from the discrepancies immanent to national laws (Berger, 2010, p. 44). In line with those efforts, it introduced so-called self-help remedies in its standard documentation. To be more precise, these remedies follow an event of default or termination. Most importantly, they differ from the existing means of support in English law (Braithwaite, 2012), which governs most cross-border derivative trades in the over-the-counter markets. The first remedy is the flawed asset clause, which allows a party to suspend performance of a transaction under the

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28 ISDA (2003) User's Guide to the ISDA 2002 Master Agreement. URL: https://www.rbccm.com/assets/rbccm/docs/legal/doddfrank/Documents/ISDALibrary/Users%20Guide%20to%20the%202002%20ISDA%20Master%20Agreement.pdf.

29 ISDA (2018) ISDA Choice of Court and Governing Law Guide. URL: https://www.isda.org/book/2018-isda-arbitration-guide/.

30 ISDA (2002) ISDA Master Agreement (French Law). URL: https://www.isda.org/book/2002-isda-master-agreement-french-law-english.

31 ISDA (2002) ISDA Master Agreement (Irish Law). URL: https://www.isda.org/book/2002-isda-master-agreement-irish-law-pdf/.

ISDA MA until the breach of contract is cured.[32] The second one is close-out netting which is a more complex concept.[33]

The ISDA MA included the terms relating to close-out netting starting from an early stage (Datoo et al., p. 262n39). Close-out netting procedure entails a certain sequence of steps leading to the calculation of a net amount (Braithwaite, 2020, p. 78n17). Once a negative event has occurred, a non-defaulting party may serve a notice on the early termination of the over-the-counter derivative trades entered before such an event. In addition to events of default such as insolvency, non-performance, cross-default or rescission of a transaction, the ISDA MA envisages termination events that are typically not related to the breach of contract.

Both remedies are purely contractual, rather than statutory. In theory, the presence of these remedies in the ISDA MA alongside common law and equitable remedies may serve yet another argument for the existence of *lex mercatoria* in financial markets. However, the relevant contractual provisions of the ISDA MA, namely sections 2(iii), 5 and 6, are interpreted by the courts of various jurisdictions in connection with applicable law. Courts in England and Australia ruled in favour of the flawed asset clause, while the US court took a more cautious approach. As for the netting provisions present in the ISDA MA, its legal nature still remains vague. Payment and novation netting are viewed as certain ways of performing monetary obligations, although applying the same approach to close-out netting is less certain (Goode & McKendrick, 2010, p. 498, 499). That said, an English court ruled that the resulting net amount to be payable under early termination provisions of the ISDA MA should not be viewed as a penalty. In doing so, it relied on a test existing in English case law, thus rejecting the autonomous nature of the ISDA MA.[34]

Conclusion

There is overwhelming evidence for the fact that ISDA contractual instruments dominate the financial world, and no other set of standard contractual terms can match them in terms of popularity with financial market participants. When entering into a cross-border transaction involving derivatives, a party thereto will almost always choose the ISDA agreement and the associated documents as a contractual framework governing their business relationship in the derivatives market. According to many researchers, non-state nature and the wide use of the ISDA MA resulted in its supranational status.

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32 Section 2(a)(iii) of 1992 ISDA MA and 2002 ISDA MA.

33 Sections 5 and 6 of 1992 ISDA MA and 2002 ISDA MA.

34 BNP Paribas v Wockhardt EU Operations (Swiss) AG [2009] EWHC 3116 (Comm) [2009] EWHC 3116 (Comm).

However, we believe that the wide use of association's documentation is insufficient to establish an autonomous legal order free from national law as the governing law of the contract. The ISDA MA, the core element of the ISDA contractual documentation, contains a governing law clause. Evidence shows that the ISDA is reluctant to produce an agreement without any reference to the laws of any state, and this approach aligns with the practice of documenting transactions in international financial markets. Facing the necessity to amend its framework agreement following Brexit, the ISDA opted for the choice of Irish and French law instead of full party autonomy.

Apart from that, we considered contractual remedies present in the ISDA MA such as the flawed asset clause and close-out netting provisions. In theory, these contractual items could be invoked by those who argue that the ISDA framework contract and related contractual instruments are the sources of the new law merchant. However, the English courts as well as the courts in other jurisdictions of the Anglo-Saxon world, interpret the relevant ISDA MA clauses based on the concepts of common law and the law of equity, quoting relevant precedents in this area rather than treating ISDA MA as a full-fledged *contrat sans loi*.

Having said that, we come to the conclusion that the ISDA MA should not be viewed as the source of the new *lex mercatoria* — at least when the latter is considered a fully a-national legal order governing international trade relations on top of national and international law. Nevertheless, we believe that, at some point, the ISDA may publish a boilerplate contract not governed by any state law and matching the status of international instruments produced by well-known codification agents in the new law merchant domain, such as the ICC or UNIDROIT.

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