

RUSSIA/UKRAINE CRISIS AND DERIVATIVES

POTENTIAL IMPACT OF EVENTS INCLUDING RESTRICTIONS ON RUSSIAN ENTITIES AND PAYMENTS IN RUB

Derivatives market participants are amongst those currently trying to assess and manage their exposures in light of Russia's invasion of Ukraine. Parties are identifying transactions which are, or could become, impacted by sanctions, export and capital controls being implemented around the world and by related market disruption, including the impact on energy and commodity prices and potentially heightened counterparty risk.

If financial institutions or companies envisage that they or their counterparty may be unable to perform obligations to pay or deliver, or any other obligation, under outstanding transactions they will need to know what this means for them under the terms of the relevant documentation, to enable them to protect their position as best they can. For example:

- **Disruption events, fallbacks and consequences:** Are settlement or pricing disruption events triggered under the terms of their agreements? What disruption events apply? Who determines whether such events are triggered? If triggered, what are the fallbacks and what are the consequences of this?
- **Events of Default, Termination Events and other key provisions:** Has an Illegality, Impossibility, Force Majeure Event or similar trigger occurred? Is there any waiting period or obligation to attempt to transfer the transaction before a party can exercise its right? Are other rights of termination triggered under the terms of the agreements? What is the interplay between such events and other provisions of the agreement or any market disruption provisions? Are there any bespoke provisions that specifically address the impact of economic sanctions programs on the parties?
- **Close-out, determination of early termination payments, alternatives to close-out:** If close-out is a possibility, which termination rights are available and what is the process for exercising them? Are there likely to be any problems associated with determination, valuation and payment of early termination payments? Does it make any difference if the transactions are collateralised? Is close-out desirable (e.g. is alternative hedging available, is close-out permitted under the terms of any hedging, would cross default provisions be triggered)? If immediate close-out is not desirable, is there any flexibility in relation to the timing for close-outs? Is there any right to suspend or withhold payment or delivery prior to close-out? Even where such rights are not (or not yet) exercisable, parties should consider the possibility of negotiated exits or other risk reducing steps such as transfers of trades to allow the offset of payments.
- **Other steps:** Practical steps can be taken to monitor and mitigate risk. In addition to reviewing documentation, parties should consider what monitoring of positions is possible using their existing systems? What restrictions can be placed on further trading that may increase risk? Is further legal monitoring (for example of counterparty solvency) possible? When considering contractual rights, parties may wish to prepare draft notices or other documentation so that the rights can be exercised quickly when required. When exercising rights and making decisions in a volatile and uncertain market, clear records should be kept in order to protect against subsequent challenge, whether by counterparties, insolvency officials or regulators.

A wide range of issues and scenarios are emerging, in part as a result of still-evolving restrictions. In this briefing we explore some of the considerations above, highlighting key issues and documentation provisions.

Disruption events, fallbacks and consequences

Disruption events are provisions designed to facilitate pricing and settlement in the event of disruption in the relevant underlying market. Not all derivatives transactions will contain disruption events. Such provisions are more common in some asset classes than others and where disruption events apply, the terms will vary. Most obligations to pay or deliver RUB are likely to be affected in some manner in the current climate, but the contractual implications may not be immediately clear and may depend on the reasons why the affected party is unable to deliver RUB. A summary of provisions relating to disruption events and fallbacks for the various asset classes, together with links to recently published ISDA documentation is included towards the end of this briefing.

In assessing the potential consequences of particular scenarios, it is helpful to understand which events and fallbacks are adopted on a market wide basis and whether such provisions are typically left in their standard form or whether they are subject to amendment by the parties. Certain market disruption provisions published by ISDA have not been included in recent definitions booklets, such as the ISDA 2021 Definitions, nor have they been made available for wide-scale multilateral adoption by way of protocol. Parties will therefore need to check whether they are incorporated expressly in their trading documentation.

Although a number of market participants are seeking to agree market disruption provisions now, ahead of any more serious market events, parties should consider carefully whether and when to do so, particularly in light of whether their hedging would operate as intended.

Events of Default, Termination Events and other key provisions

Under the ISDA Master Agreements, the consequences of a party's failure to pay or deliver under a transaction may be a Failure to Pay or Deliver Event of Default, unless the cause of that failure to pay or deliver engages another Event of Default, Termination Event or other provision. There are a variety of provisions that could be relevant depending on the scenario and the applicable terms:

- **Contractual Currency:** The Contractual Currency provisions and elections made regarding Offices and Multibranch Parties may be relevant if a party is unable to fulfil its payment obligations in the currency expressed (for example, due to exchange control measures).
- **Representations, Undertakings and Events of Default:** Provisions relating to unlawfulness and non-conflict with applicable laws may be relevant. For example, each party makes representations that its obligations are binding and enforceable and do not conflict with applicable laws. In addition, each party gives undertakings regarding compliance with applicable laws and agrees to use reasonable efforts to maintain/obtain government consents necessary for it to perform its obligations. Breach of these provisions may trigger the Misrepresentation or Breach of Agreement Events of Default.
- **Other Termination Events and Events of Default:** Other Termination Events and Events of Default could operate in this context, for example, Failure to Pay or Deliver. If capital or exchange controls are imposed or other restrictions put in place potentially making it illegal or impossible for parties to perform their payment or delivery obligations, or comply with any other material provision of the ISDA Master Agreement, the following events of default may be triggered: Illegality, Impossibility (sometimes incorporated under 1992 ISDA Master Agreement) or Force Majeure Event (under 2002 ISDA Master Agreement).

The Illegality Termination Event (in both the 1992 and 2002 ISDA Master Agreement) operates if it becomes unlawful for a party to perform its payment or delivery obligations or to comply with a material provision of the agreement. The Force Majeure Termination Event is a standard provision in the 2002 ISDA Master Agreement, but not in the 1992 Master Agreement. However parties using the 1992 ISDA Master Agreement may have incorporated the optional Impossibility Termination Event from the 1992 ISDA Master Agreement User Guide or adopted the more sophisticated 2002 ISDA Master Agreement position by using ISDA's Illegality/Force Majeure Protocol. The optional Impossibility Termination Event refers to it being "impossible" to perform or make a payment or delivery whereas the Force Majeure Event in the 2002 ISDA Master Agreement refers to whether it is "impossible or impracticable" to do so. There are many more differences between the Illegality Termination Events and

Impossibility/Force Majeure Events in the 1992 and 2002 ISDA Master Agreements which are important to be aware of.

Whether Termination Events of this nature are engaged will depend on the reasons why the affected party is not performing: sanctions, for example, may not render performance unlawful as such, but may make performance uneconomic or otherwise undesirable. It is also important to note that if sanctions do make performance unlawful, general or specific licensing arrangements may be available which if obtained, permit continued performance.

- **Sanctions provisions in derivatives transactions:** While ISDA's standard form documentation includes provisions that might be activated by sanctions (for example, the provisions noted above), it does not specifically address the impact of economic sanctions programs on derivatives counterparties or transactions in the same way as is normal in the loan market for example. It may be the case however, that bespoke provisions (such as representations, Additional Termination Events, the ability to defer payment and delivery as well as close-out and valuation provisions) are included in certain transactions.

In 2020, ISDA produced a [guidance note](#) that considers when parties may wish to include specific provisions addressing sanctions issues in ISDA documentation, the purpose of these provisions and provides examples of provisions that can be adapted by parties for use in their negotiated agreements. This guidance may be helpful for new trades.

Close-out, determination of early termination payments

Close-out of derivatives and trading positions in a volatile market, particularly if the counterparty has a significant market presence, gives rise to a range of complex practical and legal questions. These include:

- how in practice the closed out trades could be replaced or re-hedged (for example, if the volume of the position or collateralised/non-collateralised nature of the trades means a live quotation is difficult to obtain);
- what freedom a party has under its master agreements or other trading documentation in relation to the timing and process for close-outs (for example, whether early termination amounts must be calculated on the early termination date, or can be calculated later);
- whether close-out must be performed using (or by reference to) market quotations or prices, and if so whether observable prices reflect the reality of trading conditions (experience from past crises suggests this will not always be the case);
- the matrix of exposures to different legal entities both within a party's organisation and the counterparty's, and the availability of credit support including collateral and guarantees as well as the potential for set-offs against affiliates; and
- the interaction of the contractual provisions with applicable insolvency regimes.

Derivatives counterparties should, in advance of deciding to terminate derivatives transactions, understand the rights and the requirements under the relevant trading documents, the jurisdiction of the counterparty, the location of the relevant collateral (for collateralised trades) and the manner in which enforcement action might proceed in order to properly formulate a clear plan and workable procedures to implement a close-out. It should also be considered if alternatives to close-out are feasible, for example, alternative settlement for interest rate and cross-currency transactions in RUB. It is common for derivatives contracts to include the standard to act in good faith and in a commercially reasonable manner. What that will entail in practice will depend on the relevant facts and circumstances. In contrast to previous significant financial crises, there is now a significant body of English case law in respect of the ISDA Master Agreement and close-out processes, which will often be relevant.

Other considerations

In addition to the contractual analysis, it may be necessary to consider broader practical and strategic issues. For example, where master trading documentation does not make provision for a scenario, the consequences under the

general law become relevant, for example, whether the contract has been frustrated. The key questions under English law here are whether the contract become illegal or incapable of performance and whether the obligation to perform has been transformed into something “radically different” from that undertaken at the moment of entry into the contract.

Exposures related to or dependent on a contract which is considered to be at risk of disruption, may be at risk of disruption themselves. Consider for example the impact on credit support arrangements, cross-default triggers and potential asset/liability mismatch.

Summary: Disruption events and fallbacks by asset class

Commodity derivatives: Transactions entered into under the ISDA Master Agreement and the ISDA 2005 Commodity Derivative Definitions (**Commodity Definitions**) have Disruption Events hardwired into them. There are also optional Disruption Events which parties can agree to incorporate. The Commodity Definitions include fallbacks following the occurrence of a Disruption Event which can include postponement of the pricing of the transaction and “no-fault” termination. Sometimes parties agree to amend the fallbacks available, or the priority in which the fallbacks operate. Physically settled commodity derivatives tend to have different disruption events and fallbacks that apply compared to financially settled transactions. Energy supply chain issues arising due to sanctions and other restrictive measures is currently a real risk for settlement of physically settled energy derivatives.

FX transactions: Transactions entered into under the 1998 ISDA FX and Currency Option Definitions (**FX Definitions**), may contain a range of applicable Disruption Events. Related fallback provisions provide methods for determining settlement rates or alternative means of settlement of transactions following the occurrence of a Disruption Event or alternatively parties may terminate the transaction on a mid-market “no fault” basis. There is only one Disruption Event in the FX Definitions that applies automatically, and only to non-deliverable FX transactions. Any other Disruption Event needs to be specifically incorporated into the terms of a transaction to be applicable.

ISDA and EMTA recently published an [amendment agreement on the incorporation of additional provisions for use with a deliverable currency disruption event for RUB foreign exchange transactions](#), which is broadly aligned with ISDA’s published additional provisions for deliverable currencies in interest rate and cross-currency transactions, mentioned below. The amendment provides (in effect) that if a “Deliverable Currency Disruption Event” occurs which renders it impossible or illegal to deliver or convert the contracted RUB currency on settlement, the fallback is non-deliverable settlement of the transaction, with a net cash payment being payable in USD. Parties can elect for the provisions to apply to all existing relevant transactions or specific existing or even future ones.

Interest rate and cross-currency transactions: Transactions entered into under the ISDA 2006 or 2021 Definitions do not typically have disruption events applying. However ISDA has produced amendment agreements for incorporating disruption events into certain transactions. Of note, is the [amendment agreement relating to Deliverable Currency Disruption in RUB Interest Rate and Cross-Currency Transactions](#) most recently published in December 2021. The Deliverable Currency Disruption Events are “borrowed” from the FX Definitions.

Equity derivative transactions: Transactions governed by the 2002 (or 2011) ISDA Equity Derivative Definitions typically include Disruption Events that might affect the pricing, valuation or settlement of transactions. Some of these Disruption Events and related fallbacks are hardwired into the transactions and others, can be incorporated at the parties’ option. ISDA recently produced [guidance note](#) for parties to OTC equity derivative transactions affected by the Russian market closures.

For the purpose of this briefing, we have not provided a summary in relation to market disruptions and fallbacks for credit derivative transactions.

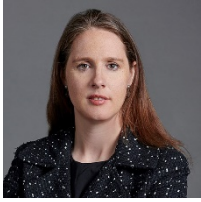
CONTACT



OLIVER WICKER
PARTNER
T: 020 7090 3995
E: oliver.wicker@slaughterandmay.com



RICHARD JONES
PARTNER
T: 020 7090 4733
E: richard.jones@Slaughterandmay.com



CAROLINE PHILLIPS
PARTNER
T: 020 7090 3884
E: caroline.phillips@slaughterandmay.com



KATHRINE MELONI
SPECIAL ADVISER
T: 020 7090 3491
E: kathrine.meloni@Slaughterandmay.com



JANSY MAN
SENIOR COUNSEL
T: 020 7090 3498
E: jansy.man@slaughterandmay.com



SAMAY SHAH
PARTNER
T: 020 7090 5104
E: samay.shah@Slaughterandmay.com



JESSICA BRODD
SENIOR PROFESSIONAL SUPPORT LAWYER
T: 020 7090 3137
E: jessica.brodd@slaughterandmay.com

London

T +44 (0)20 7600 1200
F +44 (0)20 7090 5000

Brussels

T +32 (0)2 737 94 00
F +32 (0)2 737 94 01

Hong Kong

T +852 2521 0551
F +852 2845 2125

Beijing

T +86 10 5965 0600
F +86 10 5965 0650

Published to provide general information and not as legal advice. © Slaughter and May, 2022.
For further information, please speak to your usual Slaughter and May contact.

www.slaughterandmay.com

576034687