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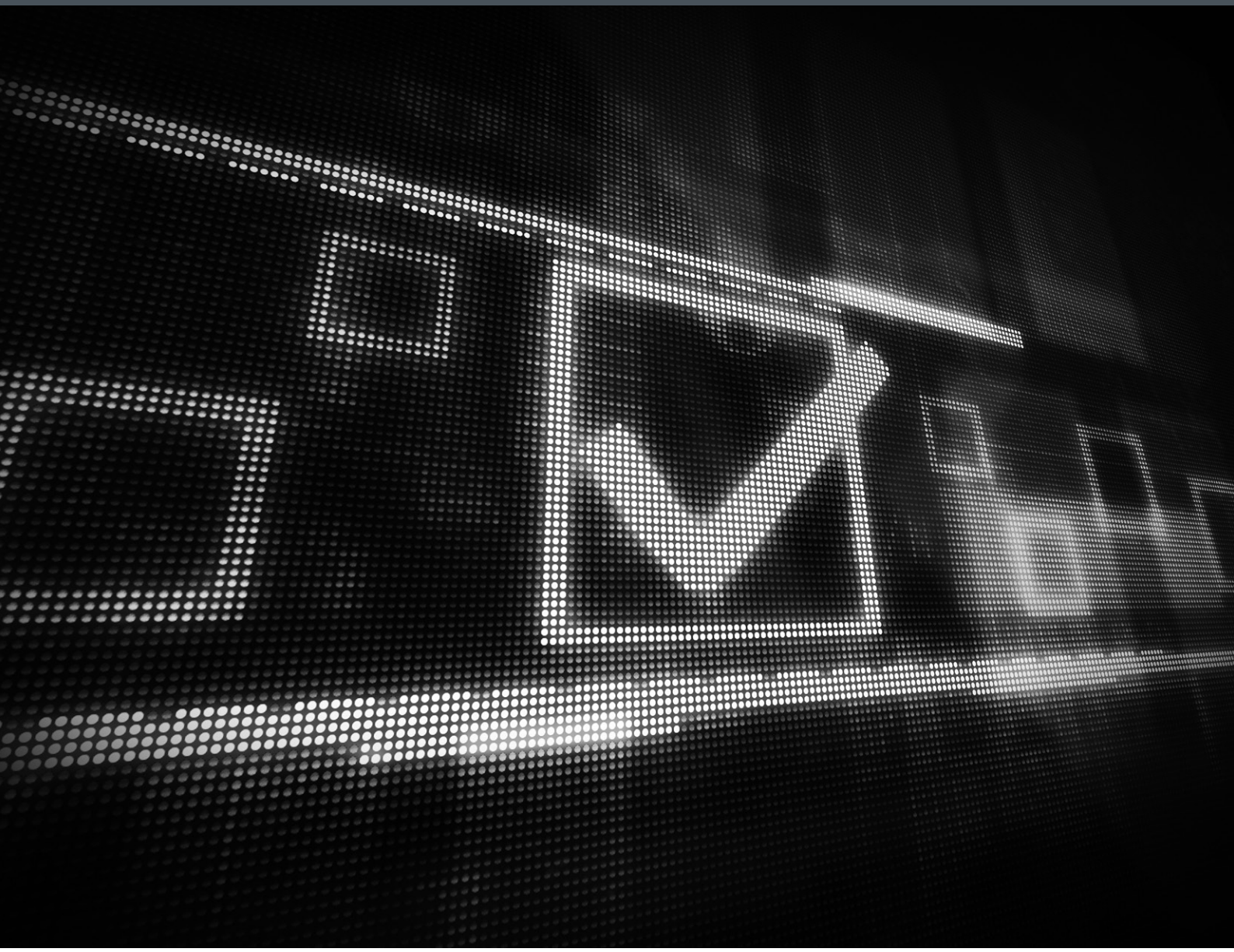

ISDA SMART DERIVATIVES - THE FUTURE?

For many of our clients, the trading of derivatives is a key element of their trading functions and risk-management processes. In light of increased regulatory requirements and an industry-wide focus on the potential benefits of automation, the International Swaps and Derivatives Association (ISDA) is now developing smart derivatives contracts. While significant progress has been made there are still considerable hurdles to be overcome before we will see smart derivatives contracts in practice.

What are smart derivatives contracts?

The term "smart contract" is hard to define and there are numerous possible definitions. In essence, smart derivatives contracts are likely to be contracts which will include some terms written in computer code and performed automatically by computer. Other terms will still require human input and control, and will still be written in natural language.

Entirely "permissionless trades", which are fully automated and irreversible, while very efficient, are unlikely to gain regulatory approval, or indeed be supported by industry participants who wish to retain an element of human involvement and responsibility in the process for risk management purposes.

What are three potential benefits to clients of using smart derivatives contracts?

- **Better regulatory compliance:** to benefit both our clients and their customers, particularly in view of increased trading, data reporting and clearing regulatory requirements.
- **Reduced complexity:** due to all market participants following the same framework.
- **Increased operational efficiencies and reduced costs:** if automation replaces manual processes, this should decrease the amount of time required to negotiate a derivatives contract and help to establish trading relationships more quickly.

What are three key challenges to the creation of smart derivatives contracts?

- **Compliance with standards –** Smart derivatives contracts must comply with various legal, regulatory, commercial and technological standards. Currently, variation in these standards across borders creates jurisdictional complexity.
- **Contractual complexity –** The "translation" of elements of a derivatives contract into computer code is painstaking and requires considerable cooperation and common understanding between computer specialists and lawyers. Some elements of derivatives contracts also require the option of flexibility or discretion. For example in event of default clauses, it is difficult to provide for automation post-default.
- **Impact of external events –** During the lifecycle of a derivatives contract, many changes can occur to a contracting party's situation – and their counterparty could respond in a variety of ways. It would be challenging to automate so many variable outcomes. National and international laws also change over time and these can impact the operation of derivatives contracts, for example, the application of sanctions laws.

How close are we to smart derivatives contracts being used in practice?

Despite the challenges, the advent of smart contracts seems inevitable as momentum towards digitisation grows. In March 2019 ISDA published its Common Domain Model (CDM) for interest rate and credit derivatives, allowing all market participants (not just ISDA members) to access and test a standard digital representation of events and actions that occur during the life of a derivatives trade. In May 2019, ISDA announced the deployment of the CDM to support the FCA, the Bank of England and other participants in testing the second phase of the digital regulatory reporting pilot for derivatives. While the CDM focuses on developing operational standards rather than legal documentation, it is intended to help develop a framework which can eventually apply to smart derivatives contracts.

In the nearer term, other ISDA products which are likely to be of interest to our clients are:

- ISDA Create – Initial Margin – an online solution allowing firms to produce, negotiate and execute documents and capture, process and store data from documents, providing a complete digital record.
- ISDA Clause Library Project – to identify provisions in the Schedule to the Master Agreement that may benefit from further standardisation.
- ISDA Definitions – ISDA is working towards digitising the ISDA Definitions.

Further reading:

- Smart Derivatives Contracts: the ISDA Master Agreement and the automation of payments and deliveries – Clack & McGonagle – 1 April 2019
- Legal Guidelines for Smart Derivatives Contracts: the ISDA Master Agreement – ISDA – Feb 2019 (https://www.isda.org/a/23iME/Legal-Guidelines-for-Smart-Derivatives-Contracts-ISDA-Master-Agreement.pdf)
- ISDA Whitepaper – Smart Derivatives Contracts: From Concept to Construction – ISDA/KWM – Oct 2018 (https://www.isda.org/a/cHvEE/Smart-Derivatives-Contracts-From-Concept-to-Construction-Oct-2018.pdf)

If you would like to discuss any of the issues raised in this briefing, please contact:

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