

Henderson on Derivatives

Second Edition
Schuyler K. Henderson



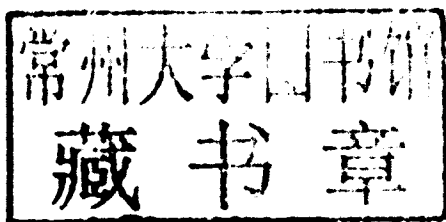
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2nd Edition

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Henderson on Derivatives

Foreword

Schuyler Henderson's book on derivatives will become the most important legal text on derivatives the moment it is in print. Henderson was present at the creation of this field and became the leading practitioner in the area. This book is a distillation of decades of experience. It rounds out in one text the varied aspects of the subject that he has counselled on and written about throughout his career.

The book wisely begins in Part I with the transactions, a complex and varied set of arrangements ranging from electricity to credit derivatives. The focus is principally on so-called over-the-counter derivatives, those not traded on organised exchanges like standardised futures and options contracts. Special attention is justly given to credit derivatives (Chapters 5 and 6). These transactions have spawned serious litigation issues over the definition of default and qualifying deliverables, and have raised policy concerns about possible distortions in the incentives of lenders that have obtained protection against default, to police the credit risk of their debtors, or to restructure debt when it goes bad. Henderson's chapters on credit derivatives are particularly valuable in tying legal issues into the language of the ISDA documentation that underpins the transactions.

Henderson's work is particularly valuable because he understands the business and law of derivative transactions. This book shows why the modern finance lawyer must thoroughly understand the basic finance and business of transactions. This is particularly apparent in Henderson's analysis in Chapter 9 of the risks of the transactions – market risk, credit risk and systemic risk. He makes a convincing case that derivatives have greatly reduced risks, despite the occasional horror show to the contrary.

Part II on the legal issues covers a wide range of problems, most of which Henderson has written on before. Particularly valuable, in my judgment, is Chapter 14 on the relationship of dealer and end user, and the duty, if any, the dealer should owe the end-user. Henderson wisely points out that different principles might apply to the dealer-dealer and dealer-end-user markets. In the dealer market, the principle of *caveat emptor* should prevail. On the other hand, where a dealer is marketing to an end-user a complex product which cannot easily be priced or closed-out, he suggests that the dealer might have a duty of a financial advisor of sorts, and should contractually clarify his obligations in that regard. This dual market concept is also taken up in Part III, covering the ISDA master agreement.

Foreword

Part III starts off with the statement that: '[t]he ISDA master agreement is perhaps the most successful financial form document ever, anywhere.' Henderson carefully navigates us in and out of its various features. He is particularly helpful in showing how the various ISDA documents, eg master agreements, definitions and confirmations, relate to each other. Chapter 16 in this Part is particularly helpful, as it looks at some of the documentation issues that have been most vexing, like withholding tax, force majeure and events of default. Another key chapter in this Part is Chapter 19, which deals with section 6 of ISDA, which establishes the amount payable on termination of a derivatives contract. Henderson is especially instructive on the use and application of the market quotation and loss methods.

In Chapter 20, he deals with the enforcement of derivatives contracts, particularly in the courts. Henderson makes a convincing point that courts will only be as good in interpreting derivatives documentation as the lawyers in front of them. Lawyers should take this to heart by being fully conversant with this book.

Hal S Scott

Nomura Professor of International Financial Systems

Director, International Financial Systems Program

Harvard Law School

November 2003

Preface to the 2003 Edition

This book deals with a topic which defies adequate definition and which is not well understood beyond a relatively few people who have spent some time working in the area. While I hope it is current on fundamental issues at the time of writing, it is *not* intended as a source book for the current law on derivatives. There are too many jurisdictions and too many different specialty areas which are relevant, not to mention the speed with which laws change and decisions are handed down. It *is* intended:

- to be an explanation of what derivatives are, or at least it is hoped that the reader will, by the end, understand what they are; and
- to provide a framework for identifying and dealing with the principal legal and documentation issues (whether as a lawyer advising a participant in the derivatives markets, a document negotiator, a regulator, a finance lawyer or litigator peripherally involved with derivatives, a credit officer, a curious student, a teacher or any other person interested in the subject).

I expect there will be two types of reader, with quite different characteristics, a likelihood which creates some organisational hurdles. The first type of reader will, probably, have some financial and legal background but little knowledge of derivatives.¹ The book is organised on a 'building block' basis, so that areas of greater complexity are dealt with after areas of lesser complexity. While it is difficult to conceive of anybody sitting down and reading this book cover to cover, later chapters do assume knowledge of earlier chapters. I have, however, particularly in dealing with the different products in the derivatives markets, used the footnotes for some of the more tedious mechanical provisions. Even here, some of those provisions, particularly those dealing with market disruptions in relation to the more complex products, are in the full text because understanding the disruptions is central to understanding the risks. Of this reader, who finishes the book, I hope it will never be said:

'A newcomer to a market is responsible for learning enough about the market to be able to survive in it; he cannot force his contracting partners to educate him. This rule makes especially good sense when it is obvious that the market is a complicated one. Everyone knows or should know that swaps are not for novices. [Plaintiff] was

¹ For this reader, who may have limited time and a low pain threshold, I would suggest: reading chapter 1 and the main text of chapter 2; skimming product descriptions in chapters 3, 4 and 5; and reading chapters 7, 9 and 10, the first halves of chapters 11 and 12, chapters 13, 14, 15 and 16, the last half of chapter 17, the first section of chapter 19, chapter 20, and the first third and last section of chapter 21.

Preface to the 2003 Edition

careless in thinking it could negotiate the shoals of swapdom without bothering to acquaint itself with the norms and customs, the traps and pitfalls, of the market into which it had wandered.²

The second type of reader, who may well have some derivatives experience, will hopefully also find parts which may change how he or she views the derivatives markets and approaches problems which arise in them. Some of the footnotes in the earlier chapters may be of interest to this more experienced reader. If parts are too elementary, skip them.

This is also a personal book. It is largely based on my experience in the derivatives market over the last 27 years and the advice I have given. This is an indirect apology for the absence of a bibliography, for which, well, I apologise. I simply have not read the secondary material that is out there. One of the reasons I wrote this book is that I got tired of being asked, particularly by students or others for whom I lectured, to recommend a good book on derivatives. I had to say, with some embarrassment, I did not know of any because I hadn't read any of them. I thought it would be easier to write a book than to go out and read a whole bunch of books (I was wrong). It did occur to me a couple of months ago that I had better do some spot secondary research, if for no other reason than to reduce the chances of making a fool of myself. I discovered, to my relief, that most of my views were not off-the-wall, and also that some of what I thought were my more interesting views were not unique. These books are referenced in the relevant areas of the text.

Given the personal nature of this book, the reader is also entitled to know my biases. In derivatives, I have represented some end-users, but mostly dealers. Among dealers, I have represented some investment/merchant banks, but mostly commercial banks. This undoubtedly reflects the fact that I was trained as a bank lawyer, which is how I would have described myself for the first half of my 32 years of practice (swaps to me just being a subset of that practice area for the first 12 years of the swap market). I was, I think, fortunate to have been trained in banking law, with a mix of transactional and regulatory experience, by lawyers from a different era: principally Dwight Fawcett, Ray Greenblatt and Dick Rosenberg of Mayer Brown & Platt in Chicago. Not only were they lawyers of exceptional intelligence and integrity, they were also gentlemen for whom the practice of law was an honourable profession rather than a business.

To say that this book is personal does not in any way mean that my thoughts have not been influenced by the clients, partners and associates with whom I have worked. In fact, it would be truer to say that they are the ones that posed questions and issues and guided and assisted me in thinking about them.³ I would particularly like to note a few of those lawyers outside of my area of expertise who, at critical times, introduced me to other areas of the law. This is particularly true of: tax, for whom my gratitude goes to Marty Belmore of Mayer Brown & Platt and Bob Dilworth and Chip Harter at Baker & McKenzie; futures regulation in the United States, for whom thanks to Bill Nissen of Sidley & Austin; and to the many partners throughout the Baker &

² *Praxair Inc v Hinshaw & Culbertson* 235 F 3d 1028, 2000 US App LEXIS 33144 (7th Cir, 2000).

³ A preface being as good a place as any for confessions, I now freely admit that many of the articles I have written over the last 20 years were in no small part an effort to get on top of new issues arising in the markets and to organise my own thoughts on them.

McKenzie network of international offices who taught me that there is a different way of looking at legal issues. I would also like to thank the many associates at those firms; working with bright, ambitious and hard-working young lawyers has been one of the most enjoyable aspects of practising law in a money centre. It is a source of pride for me to see how many have become distinguished partners at various firms or respected in-house counsel, many in the derivatives markets.

More directly related to this book, a number of people have been extremely helpful and I would like to thank them. LexisNexis provided me access to *Lexis*, which was invaluable in tracking down many of the cases cited and discussed. Most of the case quotations are from it. I hope these case discussions will provide a flavour of the markets and different judicial approaches.⁴ My secretary, Melanie Bartley, has diligently put up with my handwriting, constant changes and inordinate time requirements. Without her support, and the supplemental but invaluable assistance of Lucinda Millward, this book, literally, could not have been written. Several friends have also assisted me over the last year in obtaining materials and documents: Thinawat Bukhamana, Matthew Denning, Denis Forster, Philippa Howley, Komkrit Kietduryakal and Helen Moran.

I would also like to mention and thank my parents: my father, Bill Henderson, who was a larger than life guy who always put his family first, and my mother, Mary Henderson, who continues to suggest ways in which I can improve myself. Finally, while derivatives have played an important role in my life over the last 30 years, a job is just a job. My family, on the other hand, has been at the core. My wife of 36 years, Dr Paula S Henderson, has forged a distinguished academic career while also (I will not say effortlessly) being a loving and supportive wife and a caring and conscientious mother. I regret that my work on this book has kept me from giving the personal support she's deserved while completing her own (on a scholarly topic of far more general interest). Our two sons have, I am proud to say, ignored the example of their father and avoided the money centres in favour of careers based on service to others: Schuyler as a doctor in New York and Heath as a captain in the United States Marine Corps. To these five people, I dedicate this book.

London
July 2003

⁴ I have tended to discuss an individual case primarily in one chapter in which it is most illustrative of the particular principles for which I am using it. Other aspects of the case are also discussed more briefly in other relevant chapters. This does take away from the analysis of the case as a whole, but I hope it is a more rational approach in discussing the relevant issues.

Preface to the 2010 Edition

There has been, to say the least, a lot that has gone on in the seven years since the first edition. Two broad events are most relevant. The first is the continued increase in domination of the OTC derivatives markets by the major international banks. This domination was certainly recognised in the first edition, but its progression has resulted in a qualitatively different market. The second is the credit crunch. OTC derivatives played no significant role in it as such. Nonetheless regulatory overkill directed at derivatives has followed and purports to be justified by it, in fact representing a combination of ideology, an old-fashioned political power-grab and cynical manipulation of public opinion. The phrase “risky derivatives” illustrates a process in which, through constant repetition, an adjective becomes so linked in the public mind with the noun modified that the resulting phrase becomes a substitute for thought and achieves the status of a dogmatic truism. The insensitivity of some banks has made the process easier, but it fits within an even broader milieu.

Even though some people say we are living in a “knowledge economy,” we are living in a political atmosphere in which ignorance has more power than ever. Washington politicians who have never run any business are telling all kinds of businesses — from automobile companies and banks to hospitals and insurance companies — how they have to run their businesses. This is the golden age of ignorance in power.

Random Thoughts, Thomas Sowell, Townhall.com, June 08, 2010

One might despair of the continuance of the OTC derivatives market; others might reach the same conclusion although using a different verb with an opposite emotive connotation. Despite inauspicious omens, however, there is a fundamental vitality to the essence of derivatives technology that I believe will continue to assert itself. Maybe the \$650 trillion OTC derivatives markets will settle back to a mere \$150 trillion a year. Actually, that’s where it was when the first edition was being written.

I have continued my involvement in the OTC derivatives markets in the last seven years, albeit on a much more relaxed, and I have to say more enjoyable, basis than the preceding years. Some consulting, some lecturing and some writing have worked together nicely, I think, to keep me current enough that there is some value to this revised edition. Interestingly, putting aside a few typos and some loose drafting (of which there was a little bit more than I optimistically had first thought) and updating of numbers, there are not many *changes* to the text from the first edition. While the markets are different, the basic issues are the same. There has, however, been added throughout a great deal of *new* material, enough to make another book in its own right.

Preface to the 2010 Edition

Much of the preface to the first edition remains relevant. In respect of this edition, I would suggest for the reader with some financial and legal background, little knowledge of derivatives, limited time and a low pain threshold: reading chapter 1 and the main text of chapter 2; skimming product descriptions in chapters 3, 4 and 5; reading chapter 7, chapter 8 (paras 8.12 through 8.16), chapter 9, chapter 10 (paras 10.1 through 10.4, para 10.8 and paras 10.14 through 10.17), chapter 11 (paras 11.1 through 11.6 and para 11.8), chapter 12 (para 12.1 through para 12.16, para 12.22, and para 12.60 through para 12.69), chapter 13 (paras 13.1 and 13.2, para 13.7 and paras 13.13 through 13.25), chapter 14 (paras 14.1 through 14.3, paras 14.9 through 14.12, para 14.28 and para 14.34), chapter 15, chapter 16 (paras 16.1 through 16.7 and paras 16.18 through 16.21), chapter 17 (paras 17.1 through 17.3, para 17.5, paras 17.13 through 17.17 and paras 17.24 through 17.29), chapter 18 (paras 18.1 through 18.5, paras 18.7 through 18.19 and para 18.13), chapter 19 (paras 19.1 and 19.2, paras 19.6 and 19.7, paras 19.11 through 19.15 and annex B), chapter 20, the first third and last section of chapter 21, chapter 22 (paras 22.1, 22.5, 22.9, 22.12 and 22.14) and chapter 23 (paras 23.1 through 23.3, para 23.5, para 23.8 and para 23.9).

It would have been impossible to keep current without the support of many old, and one or two new, friends who from time to time send me items of interest. I am deeply grateful to them. They include: Jurgens Bezuidenhout, John Box, Thinawat Bukhamana, Matthew Denning, David Geen, Philippa Howley, Komkrit Kietduriyakul, Read McCaffrey, Helen Moran and Chailin Tan. For whatever reason, I am also the fortunate recipient of Morrison & Foerster financial law updates that have been most helpful.

Schuyler K. Henderson

Gloucestershire

November 6, 2010

Abbreviations

AFB	L'Association Française des Banques; www.afb.fr
AFME	Association for Financial Markets in Europe, formed in 2009 through a merger between the London Investment Banking Association and the European operations of SIFMA; http://www.afme.eu/
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht, the German Federal Financial Supervisory Authority (successor to BAKred and the insurance and securities authorities); www.bafin.de
BBA	British Bankers Association, the professional body for banks in the United Kingdom; www.bba.org.uk
BBAIRS	Interest Rate Swaps-BBAIRS Terms, published by the BBA
BIS	Bank for International Settlements, the central bank for central banks, based in Basel; www.bis.org
BoJ	Bank of Japan, the Japanese central bank; www.boj.or.jp
CBRC	China Banking Regulatory Commission, successor to the banking supervisory functions of the People's Bank of China, http://www.cbrc.gov.cn/english/home/jsp/index.jsp
CCP	A central counterparty, organized to serve as a counterparty in "OTC" derivatives entered into by one of its members and another party, similar to an exchange and to be subject to regulation under the <i>Proposal for a Regulation of the European Parliament and of the Council: on OTC derivatives, central counterparties and trade repositories</i> , September 15, 2010; called a derivatives clearing organization in and to be regulated under the Dodd-Frank Act
CDS	Credit default swap
CEA	Commodity Exchange Act, US statute regulating exchange-traded futures
CFMA	Commodity Futures Modernization Act of 2000, US stat-

Abbreviations

	ute replacing the FTP Act and rationalizing the regulatory approach to derivatives
CFTC	Commodity Futures Trading Commission, US regulatory body for futures and options under the CEA; www.cftc.gov
CLS	Continuous Linked Settlement, the real time payment netting system formed in cooperation with leading central banks and clearing through CLS Bank; www.cls-group.com
Consob	Commissione Nazionale per le Società e la Borsa, the public authority responsible for regulating the Italian securities market; www.consob.it
CRMPG	Counterparty Risk Management Policy Group, a private sector committee of twelve international financial institutions organized with the assistance of the principal US regulatory bodies, http://www.crmpolicygroup.org/ .
Dodd-Frank Act	Wall Street Reform and Consumer Protection Act, July 2010 legislation through which management of the financial markets by various Federal agencies is authorized and mandated, including Title VII, Wall Street Transparency and Accountability Act of 2010, with respect to OTC derivatives
DTCC	Depository Trust and Clearing Corporation, a company providing ancillary support services to many financial markets, including clearing, settlement and information services and custody and asset servicing in 111 countries, owned by its major customers, http://www.dtcc.com/
EBA	European Banking Authority, proposed by Council of the European Union, <i>Report on Financial Supervision Reform</i> , 13179/10 September 6, 2010
ECB	European Central Bank; http://www.ecb.int/home/html/index.en.html
EFET	European Federation of Energy Traders, a group of over 60 energy trading companies from over 15 European countries; www.efet.org
EIOPA	European Insurance and Occupational Pensions Authority, proposed by Council of the European Union, <i>Report on Financial Supervision Reform</i> , 13179/10 September 6, 2010
EFLMG	European Financial Lawyers Market Group, a group of senior legal experts from the EU banking sector, http://www.efmlg.org/index.htm
EEI	Edison Electric Institute, the US association for traders of electricity products; www.eei.org

EONIA	Euro overnight index average calculated by the ECB
ESAs	European Supervisory Authorities (EBA, EIOPA and ESMA)
ESMA	European Securities and Markets Authority, proposed by Council of the European Union, <i>Report on Financial Supervision Reform</i> , 13179/10 September 6, 2010 and to be the principal European regulator in relation to types of derivatives to be traded through CCPs
ESRB	European Systemic Risk Board, to be chaired by the president of the ECB and responsible for macro-prudential oversight of the European financial markets, proposed by Council of the European Union, <i>Report on Financial Supervision Reform</i> , 13179/10 September 6, 2010
FASB	Financial Accounting Standards Board, responsible for accounting standards (such as FAS 133 with respect to derivatives) in the United States; www.fasb.org
FBF	La Fédération Bancaire Française, the professional body of banks in France; www.fbf.fr
FDIC	Federal Deposit Insurance Corporation, the US agency which provides insurance for certain deposits of US banks and acts as receiver or conservator for insolvent US banks; www.fdic.gov
FDICIA	Financial Deposit Insurance Corporation Improvement Act of 1989, US legislation providing for netting or set-off of exposures between financial institutions
FEOMA	Foreign Exchange and Options Master Agreement, published by the Foreign Exchange Committee of the New York Federal Reserve Bank, the British Bankers Association, the Canadian Foreign Exchange Committee and the Tokyo Foreign Exchange Markets Committee, replaced by IFXCO
FERC	Federal Energy Regulation Commission, the US federal regulator of energy; www.ferc.gov
FINRA	Financial Industry Regulatory Authority, the largest independent regulator for all securities firms doing business in the United States; http://www.finra.org http://www.finra.org ; formerly NASD
FIRREA	Financial Institutions Reform, Recovery and Enforcement Act of 1989, US legislation providing for favourable insolvency treatment of derivatives on the insolvency of a US bank
FMCC	Financial Markets Law Committee, sponsored by the

Abbreviations

	Bank of England to address issues of legal uncertainty; www.fmlc.org
FMLG	Financial Markets Lawyers Group, a committee of the Federal Reserve Bank of New York; www.ny.frb.org
FOA	Futures and Options Association, representing traders in futures, options and other derivatives; www.foa.co.uk
FpML	Financial products Markup Language, a program for automatic generation of confirmations, part of ISDA; www.fpml.org
FRB	Board of Governors of the Federal Reserve System, the governing body of the system of federal reserve banks, in effect the US central bank; www.search.federalreserve.gov or www.ny.frb.org
FRABBA	Forward Rate Agreements – FRABBA Terms, published by the BBA
FSA	Financial Services Authority, the UK financial regulator under FSMA 2000; www.fsa.gov.uk
FSA 1986	Financial Services Act 1986, the UK financial regulatory statute now superseded by FSMA 2000
FSMA 2000	Financial Services and Markets Act 2000, the UK financial regulatory statute
FSOC	Financial Stability Oversight Council, a new bureaucracy established by the Dodd-Frank Act to oversee management of the US financial markets
FTP Act	Futures Trading and Practices Act of 1992, US statute exempting swap agreements from the CEA under certain circumstances, now superseded by the CFMA
G8	Canada, France, Germany, Italy, Japan, Russia, United Kingdom and United States, with the European Union attending
G10	Group of Ten (although actually eleven), consisting of Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom and United States, parties to the General Arrangements to Borrow with the International Monetary Fund
G15 dealers	Bank of America, Barclays Capital, BNP Paribas, Citigroup, Credit Suisse, Deutsche Bank, Dresdner Bank, Goldman Sachs, HSBC, JPMorgan Chase, Merrill Lynch, Morgan Stanley, Royal Bank of Scotland, Société Générale, UBS and Wells Fargo/Wachovia
GDSC	Global Documentation Steering Committee of the Federal Reserve Bank of New York; www.ny.frb.org/globaldoc

	dissolved in 2007 but with useful documentation still on its website
GMSLA	2010 Global Master Securities Lending Agreement, published by ISLA
GRMA	Global Repurchase Master Agreement, published by ICMA
IASB	International Accounting Standards Board, responsible for international accounting standards, including IAS 39 with respect to derivatives; www.iasb.org.uk
ICMA	International Capital Market Association (formerly ISMA), formed in 2005 through the merger of the International Primary Market Association and the International Securities Market Association (ISMA); http://www.icmagroup.org
ICOM	International Currency Option Master (ICOM), published by the Foreign Exchange Committee of the New York Federal Reserve Bank, the British Bankers Association, the Canadian Foreign Exchange Committee and the Tokyo Foreign Exchange Markets Committee, replaced by IFXCO
IETA	International Emission Trading Association, a non-profit organization created to provide a framework for trading greenhouse gas emission reductions; www.ieta.org
IFEMA	International Foreign Exchange Master Agreement, published by the Foreign Exchange Committee of the New York Federal Reserve Bank, the British Bankers Association, the Canadian Foreign Exchange Committee and the Tokyo Foreign Exchange Markets Committee, replaced by IFXCO
IFXCO	International FX and Currency Option Master Agreement, published by the Foreign Exchange Committee of the New York Federal Reserve Bank, in association with The British Bankers' Association, The Canadian Foreign Exchange Committee and The Japanese Bankers Association, replacing IFEMA, FEOMA and ICOM
ISDA	The International Swaps and Derivatives Association, Inc., the trade association for derivatives dealers and others active in the derivatives markets; www.isda.org
ISLA	The International Securities Lending Association, the trade association for securities lenders; www.isla.co.uk
ISMA	The International Securities Market Association, formerly the trade association for international securities dealers, now merged into ICMA

Abbreviations

IRCEA	ISDA's 1987 Interest Rate and Currency Exchange Agreement
IRS	Internal Revenue Service, the US tax authority
LIBOR	London interbank offered rate
MiFID	EU Directive 2004/39/EC on Markets in Financial Instruments
MoF	Ministry of Finance, the Japanese financial regulator; www.mof.go.jp
NAIC	National Association of Insurance Commissioners, the association for the US state regulators; www.naic.org
NASD	The National Association of Securities Dealers, the US self-regulatory body for securities houses, with some formally recognized functions; now FINRA
NCOIL	National Conference of Insurance Legislators, association of US state insurance legislators, formed to prevent encroachment by the federal government; www.ncoil.org
OSLA	Overseas Securities Lending Agreement, published by ISLA, replaced by the GMSLA
1933 Act	The Securities Act of 1933, regulating the primary issuance and underwriting of securities
1934 Act	The Securities Exchange Act of 1934, regulating the secondary markets for the trading of securities, including the exchanges
OCC	Office of the Comptroller of the Currency, the regulator of US national banks; www.occ.treas.gov
OECD	Organization for Economic Co-operation and Development, an organization the membership of which consists of thirty-three countries, including the G10
OTC	Over-the-counter, that is, not traded on an exchange
QFC	Qualified Financial Contract, a term used in FIRREA, FDICIA and the New York Statute of Frauds to cover certain financial instruments including derivatives
SEC	Securities and Exchange Commission, the US securities regulator; www.sec.gov
SIFMA	Securities Industry and Financial Markets Association, representing securities firms, banks and asset managers, formed in 2006 by a merger between the Securities Industry Association and the TBMA.
STP	Straight through processing, or the electronic processing of trade data following entry into a transaction