ICMA, ISDA, Sovereign Debt Restructuring and the Rule of Law*

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A. Introduction

Due to the economic, political and social stakes, sovereign debt restructurings give rise to major legal and political controversy. While the general attention tends to focus on the dire socio-economic situation in the debtor country, financial assets behind the repudiated debt are not some "abstract", "market" or even vilified "financial institutions" money. They constitute assets of other individuals, and can well reflect a lifetime of work and saving. This was the case of *Abaclat and others v. Argentina,*[1] filed in the name of over 60'000 retired Italian holders of Argentinian bonds. It is precisely at such moments when the rule of law is needed the most.[2] Unfortunately, misguided by their best intentions, critics of the financial sector tend to replicate the normative framework applicable to public institutions in regard to private bodies performing public functions (regulatory, disputes settlement). As a result, criticism tends to be ignored, while

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1 ICSID, *Abaclat and others v. Argentina, Decision on Jurisdiction and Admissibility*, 4 August 2011.

2 *Menkes*, Przegląd Prawa Handlowego 2017/2, at p. 31.

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the furious tone of the debate is detrimental to social trust at large. Hence, the need for a new conceptual framework to straighten certain misconceptions and further academic and public debate.

On the one hand, despite international initiatives,[3] there is no international insolvency law for sovereign defaults.[4] On the other hand, it does not mean that the law does not matter in telling unreliable political decisions-makers (in most cases their successors) from societies genuinely unable to meet their financial obligations. Domestically, insolvency law serves both as a shield and a sword: it allows to clear private markets from inefficient actors, yet it also allows to cover behind the court declaration of insolvency. Lack thereof in international financial relations makes the restructuring relatively painful and problematic, yet it also disciplines lenders and debtors not to end up in such a scenario. The former, without prospects of smoothly forcing the debtor into insolvency and recuperating at least parts of the debt, are motivated for greater attention in credit screening. The latter, risking access to capital markets, are incentivised to treat their international financial obligations seriously.

As a substitute for lacking regulation of credit relationship *per se*, the law can separately regulate the mode of conduct of both parties. Hence, the calls, including the UN General Assembly, for universal principles of sovereign lending, including the rule of law.[5] In respect of debtor states, the rule of law is often considered as a proxy for the willingness to pay one's debts (while economic data reflect the capacity to do so). "Enforcement of the Rule of Law will reduce the need for debt restructuring and hasten fair exchanges when needed."[6] Some argue it's a vicious circle of the rule of law deficiencies and sovereign restructuring: the latter both results from and furthers erosion of the former.[7] Accordingly, sovereign debt management of the restructuring process should, allegedly, be linked to adherence to the rule of law and RoL indices.[8] Calls for stricter adherence to the rule of law by debtor states are even framed – by some most renowned authors – as an appeal for an "international rule of law".[9] Others advocate a broader perception of the rule of law which, *inter alia*, could be decisive for the continuance of debt.[10] And yet one could point out that even the creditors while being very explicit about the rule of law expectations towards states, do not necessarily live up to the same standards.[11]

Commendable as they are, narratives focusing on the responsible practices of lenders and/or creditors tend to approach sovereign debt restructuring in a restrictive

3 *Esposito/Li/Bohoslavsky* (eds.).
4 *Waibel*.
5 *UN General Assembly*, Basic Principles on Sovereign Debt Restructuring Processes, *A/RES/69/319* (2015), para. 7.
6 *Goodman*.
7 *Porzecanski*.
8 Seminar *Greece and the Rule of Law*, Emerging Markets Trade Association, 30 March 2012, New York (USA). Interventions by Larry Goodman (Center for Financial Stability) and Diego Ferro (Greylock Capital Management).
9 *Stiglitz/Guzman*, a rule of law.
10 *Lienau*.
11 *Menkes*, European Yearbook of International Economic Law 2019.

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manner, taking account of only two parties to the process. However, the reality of restructuring talks is much more complex, as they involve a myriad of various public, private and hybrid bodies, which all have a crucial influence on a debtor's monetary sovereignty.[12] Now, the above criticism is echoed in respect of such complex bodies – and its rebuke by the financial sector – is driven by ideology rather than a realistic assessment of the function of finance, the rule of law and economic development.

Misguided criticism, and defences backfire as they deepen the mistrust between sector insiders and outsiders. Instead, a meaningful debate should start with academics laying a new conceptual framework for positioning all stakeholders in sovereign debt restructurings in regard to law and public interest. This article offers an instrument for straightening accrued misconceptions and allows beginning the quest for the indispensable normative framework.

B. International Swaps and Derivatives Association

I. ISDA and Sovereign Defaults

The ISDA was established in 1985 for development of the derivatives market. Its principal goals include reducing counterparty and market risk and ensuring the enforceability of their netting and collateral provisions.[13] From the perspective of sovereign financing, the most important aspects of the ISDA mandate are Credit Default Swaps (CDS).[14] In short, CDS are derivative financial instruments (i.e. contracts whose value is a function of another, underlying financial asset) designed to secure the buyer against the financial risk of an underlying financial instrument (here: public bonds), notably in case of default of the issuer.[15]

Trying to grasp the significance of the ISDA for the CDS market in quantitative terms, one can start with acknowledging that in April 2019 organisation counted 900 member institutions from 69 jurisdictions.[16] These include market participants (corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, international and regional banks) as well as key components of the derivatives market infrastructure (exchanges, intermediaries, clearing houses and repositories, law firms, accounting firms and other service providers). We thus find all key stakeholders of the CDS, the value of which in March 2019 was estimated at $8tn.[17] Although this amount is considerably lower than the 2007 peak market value of the outstanding contracts exceeding $60tn, this tendency

12 *Gruszczyński/Menkes*, in: Czapliński/Kleczkowska (eds.), pp. 371–391.
13 ISDA, *Mission Statement*; ISDA, *By-Laws of ISDA* (2018), para II.
14 *Partnoy*, Public Law and Legal Theory Working Paper 39 (University of San Diego School of Law, 2002).
15 *Kibbe/Grady/Lee*.
16 ISDA, 'About ISDA', *International Swaps and Derivatives Association,* available at: https://www.isda.org/about-isda/ (22/03/2019).
17 *Rennison/Indap*, Financial Times, 14/03/2019.

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is partly due to the economic cycle, resulting in greater attractiveness of bonds and diminished need for CDS "insurance", which sooner or later will reverse.

From the qualitative perspective, the ISDA is a *de facto* regulator.[18] The market is currently regulated, including the Regulation No. 236/2012 in the EU and law adopted in the US by the Commodity Futures Trading Commission and the Securities Exchange Commission. However, the day-to-day functioning of the market is subject to soft self-regulation; by virtue of standardised contracts (ISDA Master Agreement). As will be shown below, the market participants thus acquired the power of market regulators.

The Association also resolves disputes concerning the interpretation of CDS contracts. It is particularly interesting to note that a creditworthiness downgrade of state to a default level by credit rating agencies does not automatically trigger CDS. It is up to the Association's Determination Committees to declare[19][20] whether the credit event, i.e. actual triggering of CDS, occurred.[21] For instance, what scope or terms of partial sovereign bonds restructuring can be already considered as a credit event: should an offer of more favourable financial conditions be treated as such? In this capacity, it was the ISDA who declared a credit event, in the first publicly known sovereign CDS auction, in the cases of Ecuador in 2008, Greece in 2012 and Argentina in 2014.

The structural significance of CDS – notorious due to their role in fuelling the 2008 financial crisis – and of the ISDA itself has been strengthened by the post-crisis regulation. Portfolio diversification requirements, intended for risk mitigation, turned these quasi-insurance instruments to yet another trading asset, creating space for abuses of "manufactured defaults", whereby companies are compelled to default in a manner beneficial to CDS holders.[22] Not surprisingly, the largest cases of such questionable practices, like the *Hovnian trade*[23] or notorious Aurelius Capital Management fund litigation against Windstream,[24] drew public ire and raised normative questions. At this particular instance, the ISDA decided to self-regulate two key issues: artificial insolvency, as well as the creation of debt traded at an artificially low price

18 *Verdier*.
19 *Waibel*, Journal of Banking Regulation 2014/15(1), at p. 14, pt. V.
20 *Biggins/Scott*, Osgoode CLPE Research Paper 57 (Osgoode Hall Law School, 2013).
21 Depending on the terms of the contract, a credit event can consist of bankruptcy, obligation default, obligation acceleration, failure to pay, debt repudiation/moratorium or restructuring/modified restructuring/"modified restructuring".
22 *Smith*, Financial Times 08/03/2019.
23 Blackstone-owned hedge fund GSO agreed to refinance up to $320m debt of Hovnian, a homebuilder enterprise, in exchange for missing a bond payment, which triggered CDS. *Rennison*, '"Manufactured" credit default called off after legal challenge', *Financial Times*, 30/05/2018.
24 In this high-profile case Aurelius fund first bought Windstream bonds (and most likely CDS against the same bonds) to subsequently sue Windstream for a "sale and leaseback" transaction it had concluded two years earlier. The transaction, concluded for the development of the company, wasn't questioned by any of its bondholders. Aurelius has been accused by Windstream of bad faith litigation. The first instance judgment, in favour of Aurelius, is likely to push Windstream into bankruptcy, *Indap/Smith*, Financial Times 17/02/2019.

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in order to maximise CDS returns. The ISDA called such practices showing all resemblance of market manipulation “narrowly tailored credit events”.[25]

Aside from regulatory and disputes-settlement functions, the ISDA is also a very active participant in debates concerning reform of financial law, contributing to consultations all around the world.[26] From the personal website of its Senior Counsel, Senior Director and Head of the Financial Law Reform Group,[27] one can learn that the Association conducts “national law reform projects” in over 40 jurisdictions. It also undertakes “regional law reform efforts at EU level” in matters of ADR, and it is in dialogue with ICC, LCIA, HKIAC, SIAC, AAA-ICDR and national and regional arbitration centres. The impressive list compels one to look at the ISDA not only as a venue for and arbitrator of private transactions but also as an important stakeholder in public policy and law-making.

The ISDA has been often criticised for its regulatory activity, including the 2010 award for the Worst EU Lobbyist.[28] The Association does not spare funds for lobbying activities – the annual budget for lobbying since 2015 amounts to 2,500,000€ – 2,749,000€ (in 2014 it even reached 2,750,000€ – 2,999,999€).[29] Questionable legitimacy is further exacerbated by the perception of ISDA reform efforts as reactive, limited to the risk that had already materialised rather than taking preventive steps,[30] while number of actual problems remains untackled.[31]

I am not necessarily subscribing to the repeated claim that the ISDA regulations are biased, or worse. However, even if they are adequate, their efficiency is likely to be tarnished by legitimacy concerns.

II. ISDA Governance

The structure and governance of the ISDA[32] are regulated by virtue of By-Laws.

The powers of the ISDA plenary body (Meeting of Members), where all the primary members exercise their right to vote, are limited to the election of the Board of Directors, and for the “transaction of such other business as may properly come before the meeting”.[33]

25 ISDA, *Proposed Amendments to the 2014 ISDA Credit Derivatives Definitions Relating to Narrowly Tailored Credit Events* (2019).
26 ISDA, ‘Financial Law Reform Archives’, *International Swaps and Derivatives Association*, available at: https://bit.ly/2Fkb7hR (22/03/2019).
27 ‘Dr Peter M. Werner’, *Linkedin,* available at: https://bit.ly/2JwySbZ (22/03/2019).
28 *Oxfam International*, ‘Worst EU Lobbyists 2010 revealed – RWE, Goldman Sachs and ISDA’, available at: https://bit.ly/2CwiAdi (22/03/2019).
29 *LobbyFacts Database*, ‘International Swaps and Derivatives Association (ISDA) Lobbying’, available at: https://bit.ly/2UUhb6p (29/04/2019).
30 See *Smith*, Financial Times 08/03/2019; *Hu*, Financial Times, 24/02/2019.
31 See *Rennison/Indap*, Financial Times, 14/03/2019.
32 *Riles*, The American Journal of Comparative Law 2008/56(3), at p. 605.
33 See *ISDA*, above fn. 12, sec V(1).

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The management of the property, affairs, business and activities of the Association shall be vested in the Board of Directors,[34] which enjoys the presumption of all powers necessary for the efficient exercise of ISDA goals. The size of the Board is between 3 and 30 members.[35] Members of the Board are elected by so-called primary members of ISDA, i.e. only qualified private entities dealing with derivatives.[36] In other words, although a number of private and public stakeholders are eligible for membership, only one particular category appoints the executive body.[37] Unless otherwise expressly provided in any By-law adopted by the Primary Members, the Board of Directors even enjoys the power to amend By-laws. More importantly, the Board of Directors may appoint one or more committees of the Board; each committee shall have such powers as the Board of Directors shall properly determine (*sic!*).[38]

For instance, factual determinations on credit repudiation/moratorium, Credit Events, Successor Reference Entities or calling CDS auctions – that is all the key decisions in respect of sovereign insolvencies and restructurings – are made by the Determinations Committees.[39] It is composed of 10 voting dealers and 5 voting non-dealers, plus 2 consultative (non-voting) dealers and 1 consultative non-dealer. Currently, there are five committees (Americas, Asia excluding Japan, Australia-New Zealand, EMEA (Europe), and Japan), yet they all consist of the same financial institutions.[40] Although the most important decisions require a supermajority – which is supposed to balance position of protection buyers and sellers,[41] the most important participants of DCs (dealer members) are appointed to the DCs based on aggregate CDS trading volumes in the past year. This means that they, indirectly, buy their places. Unless otherwise decided by the DCs, requests for determination are published together with relevant documents.[42]

There is no information concerning the composition, works and procedures of the Financial Law Reform Committee publicly available and its members did not respond to my consultations requests. Aside from offering the ISDA contributions towards law-making processes of other organisations and states, the Committee is also involved in drafting the ISDA's regulation. For instance, it was involved in drafting the

34 See *ISDA*, above fn. 12, art. VI(1).

35 *ISDA-By-Laws-March-14-2018.pdf*, sec VI(3).

36 Ibid., Art. III(1)(A), VI(4)(B).

37 This can be somewhat mitigated by possible introduction of up to 9 "directors at large" from Subscribers or Associate Members, Ibid., Art. III(1)(a), VI(4)(b).

38 Ibid., para VI.

39 *ISDA*, 2018 Credit Derivatives Determinations Committees Rules (September 28, 2018 Version), Art. 1(1)(a), 3(1)(b,c).

40 Dealer (voting) members: Bank of America, Barclays Bank, BNP Paribas, Citibank, Credit Suisse International, Deutsche Bank, Goldman Sachs International, JPMorgan Chase Bank, Mizuho Securities Co. Societe Generale. Non-dealer members: AllianceBernstein, Elliott Management Corporation, Citadel Americas, Pacific Investment Management, and Cyrus Capital Partners. The only difference is that the same non-voting CCP members ICE Clear Credit LLC and LCH S.A. are member of, respectively, 4 and 2 out of 5 DCs.

41 *ISDA*, The ISDA Credit Derivatives Determinations Committees (2012), para. 2.3.

42 *ISDA*, 'Credit Derivatives Determinations Committee All DC Requests', available at: https://www.cdsdeterminationscommittees.org/credit-default-swaps-archive/ (20/03/2019).

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draft arbitration clauses for ISDA Master Agreements.[43] However, among several pages of results in the "financial law reform" archive, there are just two entries concerning ISDA's master agreements.[44] The Committee did not acknowledge more than "participation in drafting documents for CDS transactions".[45]

III. ISDA and Triggering of Sovereign CDS

Among numerous sovereign defaults, there are only three publicly known cases, where such an event triggered CDS and subsequently was auction-settled under the auspices of ISDA: Ecuador in 2008, as Greece in 2012 and Argentina in 2014. Probably there were more cases of bilateral settling of CDS, but none of them rendered public.[46]

The 2008 default predates the Association's embracement of the principle of transparency and there are no documents at the ISDA relating to that credit event available. While the ISDA website, which does not offer anything in respect of that credit event, is not proof in itself of anything, the journals with a strong economic section also hardly reported anything.[47]

The global financial crisis, European indebtedness crisis and the general backlash against financial institutions compelled the sector to change its stance towards business confidentiality. Accordingly, the Greek crisis was both broadly reported by the media and we have larger access to the relevant ISDA documents. This time the ISDA DC met twice to decide, whether the Greek debt restructuring process and the subordination of existing debt by new debt issued to the European Central Bank (ECB) constituted a credit event. On March 1, 2012, the DC unanimously (as to the unanimous decision in contentious matter see remarks below) decided that neither amounted to a credit event.[48] In respect of subordination to the ECB debt, it was held that the "specific pattern" was short of a credit event. As for the statutory introduction of Collective Action Clause in bond contracts, it was held that the mere inclusion of CACs was not the same as their activation. The latter depended on the level of voluntary participation in CAC restructuring. Once Greece obtained sufficient creditor

43 'Derivatives Disputes: ISDA revises Arbitration Guide, expanding the model arbitration clauses' (19 December 2018), Herbert Smith Freehills – Arbitration notes, available at: https://hsfnotes.com/arbitration/2018/12/19/derivatives-disputes-isda-revises-arbitration-guide-expanding-the-model-arbitration-clauses/ (20/03/2019).

44 *Wielsch*, The American Journal of Comparative Law 2012/60(4), at p. 1075.

45 E-mail correspondence, on file with author.

46 *Augustin*, Foundations and Trends in Finance 2014/9(1-2), at p. 1.

47 I did not find anything substantial from "the Wall Street Journal", "the Financial Times", Bloomberg, French economic journal "Les Echoes", or Italian economic journal "Il Sole 24 Ore", or the Spanish "Cinco Días".

48 *ISDA*, ISDA EMEA Determinations Committee: Credit Event Has Not Occurred with Respect to Recent Questions on The Hellenic Republic Restructuring, available at: https://www.isda.org/a/tLiDE/not-a-credit-event-final.pdf (20/03/2019).

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support for the newly introduced CAC restructuring, the same DC declared on March 9, 2012, a credit event.[49]

Specifics of the interpretation controversies caused by that decision go beyond the scope of this paper.[50] It is sufficient to note that the application of textualist or some other method of interpretation had grave financial implications for Greek society, for other Eurozone societies, for financial institutions and their clients. What was, in fact, a legal controversy has been settled behind closed doors of a, allegedly private, organisation. Some questioned, what is the value of CDS protection if "selective default" does not amount to a credit event.[51]

Finally, the Argentinian 2001 default (exceeding $80 billion of obligations) resulted in a decade long court and arbitration battles between the issuer of sovereign bonds and investors from all around the world. The greatest interest was sparked by the "vulture funds", which acquired the holdout debts on the secondary market for a fraction of its face value, and compelled Argentina to pay everything including interest (I come back to this point in part III.3). However, there was also a CDS 2014 epilogue. By virtue of a NY court judgment, Argentina was barred from paying its exchange bondholders about $539 million in interest, unless the holdout creditors were paid some $1.33 billion plus interest at the same time. As a result, the funds deposited with a trustee bank for cooperating creditors could not have been transferred. On August 1, 2014, Argentina was declared to be in "technical default" despite being solvent, at least to the extent necessary to restructure its disputed debt. The ISDA DC declared a failure to pay credit event.[52]

in both the Greek and Argentinian cases, the significance of the ISDCA DCs' decisions was amplified by the so-called naked CDS.[53] Such contracts are purchased by investors, who actually weren't bondholders. In other words, certain actors bought insurance without exposition to the risk, thus betting that a default would occur. Such financial speculation on sovereign default both increased its probability and multiplied the financial impact.

IV. The ISDA and the Rule of Law

Although the ISDA website does not offer anything concerning the rule of law explicitly, and, as of April 2019, even Google is clueless in this respect, actions speak louder than words. The above mentioned internal regulation, matched with numerous documents and an endless list of working groups[54] create a first impression of a robust

49 *ISDA*, ISDA EMEA Determinations Committee: Restructuring Credit Event Has Occurred with Respect to The Hellenic Republic, available at: https://bit.ly/2U3tVLT (20/03/2019).

50 *Gelpern/Gulati*, European Business Organization Law Review 2012/13(3), at p. 347.

51 *Fontevecchia*, Forbes, 22/07/2011.

52 *ISDA*, Determinations Committee Decision on Failure to Pay Credit Event occurred with respect to the Argentine Republic (2014).

53 *Ash*, Forbes, 15/07/2011.

54 https://www.isda.org/committees/ (20/03/2019).

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normative framework and full transparency (even if this enhanced transparency was instituted only in late 2018). Yet, could the abundance of information conceal substantive shortages?

In procedural terms, the supermajority requirement in the ISDA Determinations Committees, whereby interests of protection sellers and buyers are balanced, has a normative appeal. Furthermore, issues that did not acquire the necessary supermajority of 80% are transmitted to an external review.[55] This framework is surprisingly efficient, since an overwhelming majority, if not all, of the DCs' decisions are adopted by a unanimous vote. Hence, on the one hand, only contentious issues are referred to the DCs for settling. On the other, the committee consisting of numerous entities with often divergent interests reach unanimity. Two questions arise in this respect.

First, a procedural one. While the capacity to forge a unanimous compromise is both commendable and not unique to the ISDA, a lack of minutes or at least summaries of debates makes it impossible to asses whether decisions are reached through a deliberative process or rather the most prominent financial institutions are herding the others. In light of the above-mentioned participation in law reforms efforts all around the world, the "corporate veil" hindering members of the relevant committees seem problematic. In addition, occasional glimpses behind the scenes show what can be at stake and how divisive ISDA matters could be.[56]

To the extent that ISDA deliberations concern private contracts, the confidentiality of discussions *prima facie* seems defendable, although with the caveat of the possible systemic importance of such trade, which is not a private matter.[57] The same approach raises much greater concerns in respect of sovereign debtors (and defaults). Here, the so far understandable fact is that the ISDA DCs consist of financial institutions and so the general public does not even know who personally takes the decisions and what issues were considered relevant, if raised at all, concerns public-private relationship, to which I come back below.

Second, in the case of decision-making by consensus, the right to draft normative proposals, to organise the debate and summarise conclusions acquire all-new structural importance. This is well reflected by the particular status of the President of the European Council; while formally (s)he does not enjoy and hard power over European governments, the mentioned before soft powers and personal political skills can elevate this officer to the key actor in the EU legislative process.

In terms of the ISDA DCs, although these are the "eligible market participants" who have the power to notify the Committee of the "potential DC issue" or "general interest question",[58] it is for the DC Secretary to convene meetings[59] and to form the agenda by phrasing ("and rephrasing") specific questions in the form of "yes" or "no"

55 See *ISDA*, (fn. 39), sec 4(1).
56 *Bartholomew/Devasabai*, 'Isda faces member backlash on margin lobbying' (25/05/2018), Risk.net, available at: https://www.risk.net/node/5636116 (22/03/2019).
57 *Judge*, The University of Chicago Law Review 2015/82(2), at pp. 573, 611–612.
58 See *ISDA*, (fn. 27), sec2(1)(a).
59 See See *ISDA*, (fn. 27), sec2(1)(e).

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questions.[60] Interestingly, the ISDA appointed DC Administration Services Inc. as the DC Secretary.[61] DCAS is a Delaware-incorporated subsidiary of ISDA, even though the latter is registered in NYC and not Delaware. All the ISDA functions regarding to DCs have been transformed to the DCAS, which in turn was supposed to "engage various external service providers to perform certain administrative tasks", while "Citadel SPV LLC will provide management support services to DCAS in connection with the execution of its functions". Citadel SPV is a New York company providing services in respect of entity formation, governance, administration, accounting and investor reporting. While the DCAS did not respond to my queries since it is not performing any business transactions, hence it is not registered in Delaware for tax purposes, the probable cause for the multi-layered structure could be the benefit of acquiring the "highest level of confidentiality".[62]

The drafting issue, raised in respect of technical DC deliberations, brings us to the larger question of regulatory initiative within the ISDA and the impact on public interest.

On the one hand, the criteria for becoming a member of the organisation, and participating in its internal decision- and rule-making procedures, are quite liberal and the membership is publicly available. There are some 100 law firms among associate members. Obviously, there are many more financial entities. As they represent various interests, collusion to favour someone's individual interests is improbable. At the same time, given the sheer size of the organisation and the complexity of discussed matters, it is understandable why the efficiency of work requires conducting regulatory works behind closed doors[63] and the law firms – to the extent they can be considered as reflecting interests of both sides in CDS transactions – seem to appreciate the ISDA consultations.[64] To the extent that the ISDA activities concern private transactions, they arguably benefit from constitutional freedom of assembly and expression.

On the other hand, given the public interest involved, the question is, what should be the relevant normative benchmark applicable to ISDA in respect of sovereign CDS, arbitral clauses applicable to sovereign debts etc. While the ISDA by-laws and ISDA DC Rules constitute robust procedural framework, they do not reach beyond elements of the thin, formal rule of law. For instance, the DCs procedures for resolving technical questions seem advanced, as long as they are not considered as a disputes settlement venue. If the contentious issues brought before the DCs were considered as disputes then the Rules are no match to the most minimalistic arbitral procedural provisions (just to mention buy-in composition of the "jury", limited *locus standi*,

60 See See *ISDA*, (fn. 27), sec2(2)(b).

61 *ISDA*, DCAS Appointed DC Secretary (2018).

62 *Bell*, 'Delaware LLC Privacy: What's on Public Record?', available at: https://bit.ly/2UPzURI (21/03/2019).

63 'ISDA Circulates Final Master Agreement Draft', available at: https://bit.ly/2U4mCDC (22/03/2019).

64 *Peacock et al.*, 'Derivatives Disputes: ISDA revises Arbitration Guide, expanding the model arbitration clauses' (19/12/2018), Arbitration notes, available at: https://bit.ly/2HFAYVc (23/03/2019).

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lack of transparency both in terms of proceedings and justification of final decisions, lack of appeals mechanism).

Whether, and to what extent, the technical nature of CDS contracts can and should be subject to substantive requirements of the rule of law, goes beyond this paper. In my opinion that is highly questionable. However, it does not change the fact, from the rule of law perspective, the current ISDA model meets only selective conditions of the formal rule of law.

C. International Capital Market Association

I. ICMA and Sovereign Defaults

The history of today's International Capital Market Association (ICMA) began in 1969 in Zurich with the registration of the Association of International Bond Dealers, for the Eurobonds market, under Swiss law.[65] In the 1980s, the AIBD was recognised in the United Kingdom as an International Securities Self-Regulating Organisation, i.e. a regulatory NGO. Organisation also opened AIBD Ltd., a wholly-owned subsidiary, to provide data services to the market from London. Subsequent auxiliary structures have been gradually added, and the mission broadened from Eurobonds to a variety of issues arising at capital markets. In 1992, the AIBD changed its name to "International Securities Market Association" (ISMA). In 2005, it merged with the International Primary Market Association (IPMA) and took the current name. Currently, the ICMA is active in all segments of the wholesale international debt capital market.

The ICMA's mission is to "promote resilient and well-functioning international debt capital markets".[66] Its most tangible impact on sovereign debt restructuring is soft regulation in the form of guidelines, rules, recommendations and standard documentation. The two most important from the perspective of this paper are Collective Action Clauses (CAC) and *pari passu* clauses. Another instrument, which might become an important element of sovereign financing legal framework, is the Sovereign GDP-Linked Bonds, introduced by the organisation in 2017.[67] The latter seems all the more interesting from the international law's perspective that, in light of their explicit contribution towards the issuing state's economic development, they seem more likely to be subject to investment arbitration scrutiny.

The significance of soft laws (model laws) is a function of their recognition among market participants. As of April 2019, there were over 560 members of ICMA from 62 jurisdictions.[68] Full members are entities actively dealing with securities: investment banks and issuers, securities dealers and brokers, regional and commercial banks, private banks, and asset managers, but also trading venues such as recognised stock

65 *ICMA*, 'About ICMA. History', available at: https://bit.ly/2IJxth9 (26/04/2019).
66 *ICMA*, ICMA Mission Statement (2013).
67 *ICMA*, Sovereign GDP-Linked Bonds: Design, Investor Response and Open Issues (2017).
68 *ICMA*, Membership, available at: https://bit.ly/2GCA74E (26/04/2019).

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exchanges and multilateral trading facilities, and central counterparties, clearing and/ or settlement systems. Other organisations "playing an important role in the market and maintaining close relations with ICMA" are entitled to become associate members. This category includes government institutions, central banks, credit rating agencies and legal firms. In other words, representatives of the most important market participants and major service providers are personally involved in the popularisation of these standards. It is worth noting to note that the value of the investment-grade bonds is currently estimated at $52 trillion, meaning it has doubled since the global financial crisis.[69]

Aside from its regulatory function, the ICMA prides itself with influencing market practices and its functioning. Its activities include representing its (buyer) members in interactions with regulators, brokering dialogue between market participants and governments, regulators and central banks. It also engages in various networking initiatives (e.g. a mentoring programme)[70] and, most importantly, it established the ICMA Centre at the University of Reading.[71] The Centre is "the first active collaboration between the securities industry and a university finance department", providing educational services to undergraduates, master's students, PhD students, and Executive Education. This means that the ICMA's soft power is stronger than the traditional Anglo-Saxon influence over international economic organisations.

The ICMA also provides conciliation and arbitration proceedings "to members and other interested parties with regard to disputes arising out of transactions in international securities regulated by ICMA as well as disputes between a member and the Association in respect of certain matters arising out of ICMA's statutes, by-laws, rules and recommendations". I did not find any information about the actual functioning of this disputes settlement mechanism. One should hope that it means that the ICMA has not performed such functions concerning sovereign debt instruments.

Unlike the ISDA, which gets bad press, the ICMA is surprisingly low on the public radar. Additionally, the ICMA's public image was certainly boosted[72] by their green, social and sustainability bonds project,[73] even though the green bonds initiative is not free from controversy.[74] In line with observations below, the still-nascent green bond market with its decentralised governance was described as "often faster to implement and more responsive to the needs of market participants [than public regulators] but

69 *McCormick/Greifeld*, 'Hidden Bond Market Dangers Expose Traders to $2 Trillion Wipeout', Bloomberg Business Week (2019), available at: at https://bloom.bg/2IeNtau (27/04/2019).

70 *ICMA*, ICMA Mentoring Platform, available at: https://bit.ly/2scy7LY (27/04/2019).

71 *ICMA Centre*, About Us, available at: https://bit.ly/2GNbBir (27/04/2019).

72 *Thomas Hale*, 'When finance becomes a beneficiary of the green agenda', Financial Times, 5 January 2018.

73 *ICMA*, Green, Social and Sustainability bonds, available at: https://bit.ly/2NPhKzg (27/04/2019).

74 *Rose*, Capital Markets Law Journal 2019/14(1), at p. 59.

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may suffer from a lack of legitimacy, accountability, and consistency and be susceptible to greenwashing."[75]

Although I'll come back to the actual costs of mere suspicion that a particular organisation is biased and serving some opaque interests in the conclusions, it is worth noting at this point that, while details of the ICMA's structure, its internals laws and proceedings are not public, this organisation is also very vocal in public debate (consultations) on capital markets law.[76] The ICMA employs 6 registered lobbyists working at 25% (full-time equivalent 1.5), with a gradually increased lobbying budget. Until 2013, annual lobbying costs were in the range of 50,000€ – 100,000€, in 2014 some 200,000€ – 299,999 € and since 2015 300,000€ – 399,999€ (the number of registered lobbyists dropped by half).[77] Accordingly, the ICMA has even been dubbed as a (bank) lobby organisation.[78]

Finally, while the Association represents both the selling and buying side of the market, its membership structure lacks equilibrium in geographical terms. It is dominated by institutions from the US, the UK and France with a significant German presence. While it is not surprising, as a reflection of the domestic capital market maturity and size, and one could hardly expect compulsory membership, it raises questions at least in terms of the ICMA's impact on transnational capital transactions-operations of multinational financial organisations. Seats of these most powerful institutions overlap with the ICMA's geographical representation. How national interest – between the home and host states for such institutions – can conflict could be observed during the post-crisis reform of financial supervision in the EU.[79]

II. ICMA Governance

The principal body of the Association is the General Meeting. Each ICMA full member is entitled to one vote and, unless otherwise provided in the statutes, the general meeting adopts resolutions by a simple majority. The GM enjoys, *inter alia,* powers to amend the statutes by a majority of two-thirds of the votes present, elect board members and terminate their mandate, elect the auditors, approve the accounts, determine the annual subscriptions to be paid by members, and decide on the termination of the Association.

Strategy and major policy matters are decided by the Board. The Board also supervises the Chief Executive, the executive committee and the functions of the ICMA generally. It consists of 22 members appointed for a 3-year term. 21 of the Board

75 *Park*, Stanford Journal of International Law 2018/54(1), available at: https://papers.ssrn.com/abstract=3142887 (27/04/2019).

76 See for instance a summary of "practical initiatives" presented by the Association in its quarterly report, *ICMA*, ICMA Quarterly Report Second Quarter 2018, p. 25.

77 *LobbyFacts Database*, 'International Capital Market Association (ICMA) Lobbying', available at: https://bit.ly/2PCQodV (28/04/2019).

78 'Bank lobby ICMA urges Europe not to leave Britain behind in capital...', Reuters, 29 September 2016, available at: https://reut.rs/2IXcO8B (27/04/2019).

79 *Menkes*, International Journal of Management and Economics 2013/37, at p. 130.

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members are normally elected by the General Meeting, and the Board itself chooses its last member and chair, the Chief Executive. The structure of the Board should reflect the geographic composition of the Association, the current importance in the international capital markets of particular regions or areas, and the various functions in the markets. In line with earlier remarks in respect of the ISDA, the result is a double privilege for financial institutions from 3-4 states. As of April 2019, the Board consists of 16 members. All of the directors are based in Europe and 9 of them are from London.[80]

What's more, candidates for the ICMA bodies are nominated not by members of the General Meeting, but by the Nomination Committee. The NC consists of 9 members, 4 of whom are appointed by the board from board members and 5 are appointed by the regional committees. Accordingly, almost half of the nomination power for, *inter alia*, the Board belongs to the Board itself. As for the remaining 5, they are appointed by 15 regions. Regional constituencies stretch from single posts (e.g. Belgium, Germany, Italy or Netherlands), to groups of 2-3 jurisdictions (France and Monaco, Switzerland and Liechtenstein, the US and the UK and Canada and 4 Latin American states), to large baskets (e.g. the group for Asia-Pacific, or Central-Eastern and Turkey group). Decisions of regions are, presumably, taken by The Committee of Regional Representatives. Yet, again, nothing is publicly known about the latter. In addition to the nomination power, the Nomination Committee also fills vacancies on the Board for the remaining part of the term.

While some extracts from relevant statutes and information about the structure of the ICMA principal organs are available, hardly anything can be found in respect of bodies dealing with specific issues. For instance, the Board exercises its supervisory role through the Audit, Compliance and Governance Committee which oversees compliance by the Association with all laws, rules and regulations, the Oversight Committee which supervises the executive committee and any committee established by the executive committee. There is nothing in the public domain about these key supervisory bodies (or results of their works) or a plethora of subject-specific bodies whose existence is barely acknowledged by the ICMA.[81] This is notably the case of the cryptic ICMA's European repo and collateral council, which "for many years (…) sponsored the Global Master Repurchase Agreement (GMRA), the most predominantly used standard master agreement for repo transactions in the cross-border market". [82]

III. ICMA and Contract Model Clauses

Among a number of initiatives potentially significant to the sovereign debt market – including the draft initiative of *hurricane bonds*, with a debt reprofiling feature, GDP-

80 *ICMA*, The Board, available at: https://bit.ly/2GIqyRN (29/04/2019).
81 *ICMA*, Organogram, available at: https://bit.ly/2J2tqM8 (29/04/2019).
82 *ICMA*, The European Repo and Collateral Council, available at: https://bit.ly/2J1YwmZ (29/04/2019).

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linked bonds or the above-mentioned green bonds – the ICMA has published model collective action clauses (CACs), *pari passu* and creditor engagement provisions for sovereign debt instruments.

Pari passu in Latin means "equal footing". For the purposes of financial law, it denotes a clause, by virtue of which all creditors are entitled to the equal treatment – no creditor should be discriminated by the debtor. This provision prevents the debtor from subordinating the debt to newly issued instruments and from restructuring part of the debt in a way that would negatively impact the others.

While the *ratio legis* behind the clause seems equitable, it may lead to abusive practices. Since debt restructuring requires the consent of all concerned creditors, it may be economically reasonable to abstain from restructuring talks until other creditors reach an agreement, and then blackmail the restructuring with a demand of full payment. This is the so-called problem of a holdout creditor.

The *pari passu* clause emerged at the forefront of sovereign debt restructuring, and became a catalyst for the reform of the law, Argentina's default in 2001 on ca. $92 billion sovereign debt and the 15-year legal battles saga.[83] Rather than sue for contract debt, some holdout creditors decided to block restructuring by relying on this clause. The grand finale to the story was written in 2014, when Argentina was forced into another default by a court ruling. A New York judge interpreted the *par passu* clause in a manner favourable to holdouts, simultaneously issuing an injunction that barred Argentina from paying restructured debt but not holdout claims. The judgment was surprising, as the *par passu* clause had not been applied so far to payments. The ruling has been upheld by the US Supreme Court. As a result, two investment funds managed to twist Argentina's arm and holders of 93% of its debt, who had agreed to a haircut of 30 cents on the dollar.[84]

One result of Argentina's court battles was the issuance in 2014 of new model wording for the *pari passu* by ICMA. The new clause aims precisely at preventing courts from ruling that debt restructuring hinges upon payment of holdout creditors (it covers legal subordination only and not actual equal payments).

Another solution to the holdout risk is provided by the Collective Action Clause. By virtue of this contractual provision, the issuer(s) and a qualified majority of creditors are entitled to modify the terms of the instrument. While CACs have been routinely used in English law, bond instruments governed by New York law historically did not include CACs. Also, the New York law-governed sovereign debt instruments replicated the unanimity requirement.[85] As it turned out, without international bankruptcy law, unanimity was not a good standard for sovereign lending. Eventually, following the Argentinian bond-restructuring saga and the IMF proposal of a Sovereign Debt Restructuring Mechanism from 2001, the industry pressured

83 See *Menkes*, Przegląd Prawa Handlowego 2017/2, at p. 31.
84 *Solomon*, The New York Times, 21 December 2017, available at: https://nyti.ms/2UMbxn7 (29/04/2019).
85 *Stolper/Dougherty*, Capital Markets Law Journal 2017/12(2), at p. 239.

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sovereign issuers into including CACs in their NY-law governed contracts from 2003 onwards.[86]

Of all the variations, ICMA, with the support of the IMF,[87] advocates for three model clauses in its standard form CACs. The difference concerns the constituency required to and effects of restructuring. A choice may involve decisions adopted by bondholders in *series-by-series* votes, or through a multiple series of bonds vote, yet the restructuring must be approved both by all bondholders voting together and by bondholders voting within their particular bonds (*two-limb voting*), or multiple series of bonds, with one aggregated vote amongst all bondholders (*single-limb voting*). Majorities required for a particular decision may differ, depending on whether they belong to reserved or ordinary matters.

IV. ICMA and the Rule of Law

In terms of the Rule of Law, the ICMA recognises that "[t]he arbitrary exercise of regulatory or political power, for instance in the form of unexpected policy or regulatory changes or the unilateral renegotiation of existing contracts by new governments, does [not] incentivise investors who require (…) regulatory and policy stability (…). A coherent and trusted legal framework (…)is also necessary to ensure that the rule of law takes precedence, as opposed to subsequent government decisions. Investors need to be confident that the legal system of a particular jurisdiction."[88] Some other documents express ICMA's Rule of Law expectations in regard to public authorities. However, I could not find any hint of recognition that the same set of principles should apply to the Association itself.

Now, the starting premise for further observations is a generally positive reaction to the ICMA CAC/*pari passu* model clauses,[89][90] even if the support was not unequivocal.[91] The sector is, indeed, anxious for the new model clauses to replace the old versions (while expecting legal controversy in the transition period).[92] One could thus conclude that the model clauses met everyone's expectations, hence the lack of rule of law constraints did not result in an interesting capture while, presumably, safeguarding efficiency of consultations.

Yet, the contractual reform of the sovereign debt market, as an alternative to a treaty approach, won the day. It is espoused by the IMF. A number of documents mentions

86 *ILA*, Sovereign Bankruptcy Study Group. Report presented at Johannesburg Conference 2016.
87 *IMF*, Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring 2014.
88 *ICMA*, 'European infrastructure finance: a stock-take' (July 2017), available at: https://bit.ly/2ucwf6j (30/04/2019).
89 See *ILA*, (fn. 86).
90 *Jewett/Peihani*, Policy Brief 108 (Centre for International Governance Innovation, 2017), pp. 6-7.
91 *Stiglitz/Guzman*, A Step Forward.
92 *Moody's*, Moody's answers frequently asked questions on new ICMA sovereign bond clauses (2015).

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coordination-cooperation between ICMA, the US Treasury and the "US Treasury-led working group".[93] While academic members consulted by the group convened to "coordinate approaches to contract reform" do not conceal their engagement[94],[95] and the proceedings are mentioned in numerous sources, I could not find anything tangible on the group *per se.* The Chairman of this "roundtable", the Treasury's Mark Sobel, even summarised its works for the general public, yet without information such as who was invited, who formulated the conclusions and how, or what was the scope of consultations with non-members.[96]

In the end, the ICMA was shielded against criticism by referring to consultations with the US Treasury and the IMF. The US, describing the talks as a "roundtable" rather than a US-led coordination endeavour, relies on the participation of the ICMA and the IMF. The Fund protects the integrity of its mission by citing the other two. Still, it just one opaque self-proclaimed private organisation, a single government and an international organisation (whose engagement is unclear and which remains under the predominant influence of the same jurisdictions that dominate the ICMA).

The lack of transparency, which conceals a possible lack of other Rule of Law features of law making, does not necessarily cover any dirty truth. Yet, the impact upon the legitimacy of solutions, and as a result the stability of the financial sector, can be equally detrimental. Given the sensitive nature of public education, there are even stronger reasons, why the Association should be transparent and subject to some public scrutiny.

D. Private Stakeholders in Sovereign Debt Restructuring: the Role and the Rule of Law

Public debates concerning the financial sector suffer from deep distrust between market insiders and outsiders. In the case of sovereign restructurings, where the future of a whole nation is stacked against private interests, emotions reach the zenith. In such circumstances, the rule of law has particular significance, as it provides the comfort of fair treatment to those suffering hurdles of fiscal consolidation. Understandably, sovereign debt restructurings attract major attention. On the one hand, critics demand full public scrutiny, without a distinction between the public, private or hybrid nature of financial institutions. On the other hand, financial institutions, and their sometimes suspicious associations,[97] sometimes arrogantly refuse to talk, insisting on their private-law origin. Both narratives are misguided and dangerous, as they blur the proper relationship between financial markets, the rule of law and public policy goals.

Starting with *de facto* regulatory powers of such associations, operating in between the public and private sphere: "[r]ecurrent transactions almost inevitably generate

93 *Makoff/Kahn*, CIGI Papers 56, at pp. 1, 3.

94 *Gelpern/Heller/Setser*, 'Count the Limbs: Designing Robust Aggregation Clauses in Sovereign Bonds', in: Guzman/Ocampo/Stiglitz (eds.), pp. 109–143.

95 *Gelpern*.

96 *Sobel*, Capital Markets Law Journal 2016/11(1), at p. 3.

97 *Durkee*, Stanford Law Review 2017/69, at p. 201.

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network effects and thus natural standardization. Widespread rules like the *pari passu* clause (…) therefore shape contracts at least as much as the norms of state dispositive law. However, whereas legal norms can mostly be attributed to the legislator, private standards have so far appeared to be "heteronomy without heteronomous agents."[98]

Financial markets thus wield power that is supposed to serve an instrumental function to economic growth and public interest. Now, ethical decisions – of what serves both the private and public interest – are inseparable from financial institutions themselves. "If institutions are to flourish, they need virtues; if virtues are to be cultivated, they need institutions".[99] Instead, if financial theory comes before morality and the relationship with oneself and the world, the organisation becomes driven by ideology.[100] It is a degenerative situation: if ideology originally facilitates the constitution of power, subsequently it becomes an active component of that power.[101] As a result, believers in "inevitable" financial progress[102] become increasingly blind to the social impact of their actions.

Accordingly, scholars analysing ossification of *pari passu* clauses discovered "[t]he themes that emerge from our respondents' stories highlight the disconnect between the idealised model of transactional lawyering and the everyday reality of sovereign debt legal work. In a sense, the stories help bridge that divide by providing an explanation for lawyers' relative powerlessness and by imbuing the "ritual" of sovereign debt contracting with meaning."[103]

The structure fuses with the purpose. As one scholar observed, the ISDA is "privately-funded legal R&D consortium", which both allows sector collective actions and lobbies on its behalf.[104] ISDA thus "functions as a mechanism through which swap dealers can effectively promote their collective interest (…) intermediaries prefer institutional arrangements that yield higher transaction fees, and (…) are often well positioned to promote self-serving arrangements. As a result, high-fee institutional arrangements often remain entrenched even in the presence of more-efficient alternatives".[105] Blind obedience to financial paradigms "leads to a paradoxical result: rather than theory, or rather ideology, serving power, power begins to serve ideology."[106]

Financial inefficiency aside, regulatory capture erodes social trust, which constitutes the fundament of both capital markets and any complex social interactions beyond imminent family and friends.[107] It actually is irrelevant, whether regulators *de facto* serve any specific interest or not; the mere suspicion that a sovereign default

98 *Schuppert*, 'From Plurality of Normative Orders to Plurality of Norm Producers', in: The World of Rules, p. 186. Quoting *Engert*, Rechtswissenschaft 2014/3, pp. 301–340.
99 *Snyder*, p. 12.
100 *Havel*, p. 7.
101 Ibid., at p. 10.
102 See *Snyder*.
103 *Weidemaier/Scott/Gulati*.
104 *Hu*, The Yale Law Journal 1993/102(6), at p. 1457, at para. 300.
105 *Judge*, The University of Chicago Law Review 2015/82(2), at p. 573.
106 See *Havel*, at p. 11.
107 *Sztompka*.

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occurs because or in a manner favouring anyone's financial interests is equally disastrous to the legitimacy of international economic order.[108]

The ever more complex international economy,[109] with new public-private entities, *de facto* performing public functions, makes the task of constructing an adequate normative framework even more daunting. The geometry between such bodies, occasionally performing law making or even academic education (like in the ICMA case), public and private interests is variable, and the two associations analysed in the paper remain impregnable as to their conviction about own private nature.

While the public function must be firmly grounded in the rule of law, for the sake of economic and social progress,[110] this is unlikely to change without sufficient public pressure and meaningful debate. So far, outsiders somewhat tendentiously criticise one association (ISDA) and ignore the other (ICMA). As a result, the former oversupplies documents of scarce significance for public scrutiny, while the latter discloses hardly anything.[111] It is high time for both the financial sector and (academic) critics to undertake their respective responsibilities.

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108 *Lessig*.
109 *Slaughter*.
110 *North/Thomas*..
111 *ICMA*, Meeting of the Group of Trustees of the Principles. Statement by the Co-chairmen on behalf of the Group of Trustees (2018).

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