

Clients & Friends Memo

Posting Independent Amounts under Derivative Transactions: Industry Recommendations for End User Protection

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Introduction

Credit risk associated with derivative transactions can be managed through a variety of methods such as effective payment and close-out netting arrangements; the use of central clearing counterparties; and effective collateral arrangements. In the context of collateral arrangements, dealers often require end users to provide collateral in an amount which exceeds the amount of the dealer's credit exposure. This is commonly achieved by requiring end users to deliver independent amounts ("IA").

The requirement to post IA presents end users with additional risk – the risk of loss of IA in the event of the dealer's insolvency. This risk became all too clear during Lehman's insolvency where a large number of Lehman clients (both in Europe and in the US) were unable to obtain immediate recovery of their excess collateral and were left with unsecured claims. As a result, there is now a strong desire on the part of end users to ensure that IA posted to dealers are held in a manner such that they are immediately recoverable in the event of the insolvency of the dealer.

To address such concerns, the International Swaps and Derivatives Association, Inc. ("ISDA"), the Managed Funds Association ("MFA") and the Securities Industry and Financial Markets Association ("SIFMA") have recently published a paper (the "Paper"¹) on IA posted as collateral under derivative transactions. The Paper provides recommendations to market participants on how collateral providers posting IA can protect themselves from the risk of loss of IA in the event of the insolvency of the collateral taker. The scope of the recommendations made in the Paper extends to OTC derivative contracts – it does not extend to cleared derivatives.

¹ See ISDA, MFA and SIFMA "Independent Amounts", Release 2.0, 1 March 2010, available at http://www.isda.org/c_and_a/pdf/Independent-Amount-WhitePaper-Final.pdf

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What are Independent Amounts?

IA increase the overall amount of collateral that an end user is required to deliver under a derivative transaction – the underlying commercial rationale being to provide an additional buffer of protection to dealers to protect against certain risks – including risks arising where: (i) there is market volatility and a delay before new collateral requirements are computed, called and settled; (ii) the dealer's exposure increases after the default of the end user as a result of market fluctuations prior to the dealer closing out its position; (iii) margin payments are not made because they fall below an agreed threshold amount; and (iv) there is a discrepancy between margin valuations (based on mid-market values) and default valuations under the ISDA Master (depending on the method used upon close-out).

Existing methods to hold IA

(a) *IA Posted Directly with the Dealer or its Affiliate:* If IA are posted by an end user with the dealer or its affiliate, this is done through an arrangement involving either an outright transfer² or a security interest coupled with a right for the dealer or its affiliate to rehypothecate the collateral³. In either case, in the event of the insolvency of the dealer, it is likely that the end user would be left with an unsecured claim for the return of IA.

(b) *IA Posted with a Third Party Custodian of the Dealer:* Where the dealer keeps IA with a third party custodian, the end user will not have privity of contract with the custodian and therefore no contractual right to require the custodian to return IA in the insolvency of the dealer. However, the use of a third party custodian usually allows traceability of collateral⁴ thereby affording certain statutory protections in a number of jurisdictions⁵. However, where a third party is used, but the collateral is then rehypothecated, it is likely that such statutory protections will not apply and the outcome would be similar to that under the direct holding scenario described under (a).

(c) *IA Posted with an Agent Appointed by Both Parties:* This involves both the end user and the dealer appointing⁶ a third party agent to hold collateral in the name of the end user but subject to a security interest granted in favour of the dealer. Each of the end user and the dealer have privity of contract with the custodian and therefore the right to direct the custodian to deliver collateral to one party in the event of a default by the other party.

² Using an English law governed CSA

³ Under a New York law governed CSA

⁴ For example, where the end user has the custodian's name, address and the relevant account number

⁵ In the UK, for example, the applicable client asset rules may apply if assets are segregated and held in the name of the client

⁶ Under a tri-party agreement between the two derivative counterparties and the custody bank

Alternative (a) above has been the most common arrangement used to hold collateral – largely due to the increased liquidity provided to dealers under that arrangement and the associated cost savings to end users. Although market participants are increasingly looking to alternatives (b) and (c) because of the additional protections afforded to end users, the higher transaction costs associated with these alternatives have made them less popular to date.

Recommendations for Posting Independent Amounts

Below is a summary of certain of the recommendations of the Paper:

- Collateral taken under title transfer arrangements should not be segregated or have any limitation on the receiving party's ability to freely use the collateral. Any segregation or limitation on use would raise recharacterisation issues.
- Collateral that is intended to be segregated should be governed by a security interest arrangement. Parties may consider utilising hybrid title transfer/security interest arrangements, having considered the legal issues associated with the operation and enforcement of hybrid arrangements⁷.
- Unless otherwise required by law or regulation, unrestricted direct dealer holding of IA should continue to be an available option; dealers should consider the use of disclosure statements for certain counterparties outlining the risks associated with such arrangements.
- Both dealers and end users should consider a range of alternative holding arrangements for IA that include features designed to manage for both parties the risks and benefits associated with IA. (Legal advice in respect of the risks and benefits of the various structures in the relevant jurisdictions is highly recommended.)
- Parties should consider who should bear the risk of loss in the event of the insolvency of an independent tri-party collateral agent, and ensure that this responsibility is clearly documented between them.
- All parties should, subject to local law requirements, continue to be able to hold collateral to cover variation margin ("VM") free of any segregation requirement, restriction on rehypothecation or other limitation. When using the English Credit Support Deed, parties should consider whether the arrangement constitutes a security "financial collateral arrangement" and, if so, whether it is preferable to amend the Deed to permit rehypothecation and remove the requirement to segregate or whether the English Credit Support Annex should be used for VM.

The Paper also makes a number of recommendations for market evolution:

- ISDA should develop a standard form of amendment agreement that permits the parties to a New York Law CSA to accommodate treatment of a segregated IA as a

⁷ Such hybrid arrangements may involve the use of a security interest arrangement in respect of IA and a title transfer arrangement in respect of variation margin

separate pool of collateral. This form of amendment could provide, subject to the parties' preference, that either (i) IA and VM collateral pools are delivered separately, with two separate cash flows and no netting; or (ii) IA and VM are netted.

- As sufficient industry experience and feedback on the foregoing proposals emerges over time, ISDA should consider updating its range of collateral legal opinions to take account of the above documentation changes.

Conclusion

Balancing the conflicting interests of dealers and end users will continue to raise difficulties in practice. End users are increasingly concerned with the risk of loss of IA in the insolvency of a dealer. The Paper considers a number of alternative collateral arrangements which provide end users with protections in this regard. However, such alternative collateral arrangements may involve higher operational costs for dealers, higher transaction and financing costs for end users, higher custodial fees for end users, third party custodian or agent insolvency risk and, in the near term, a lack of standard, industry-wide documentation for these new collateral arrangements and increased time in negotiating and executing derivative documents.

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