

Clients & Friends Memo

ISDA Publishes Final Collateral Dispute Resolution Procedure Designed to Assist Market Participants in Resolving Disputed Collateral Calls

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Introduction

Under normal market conditions, collateral disputes usually get resolved informally between the parties. However, during periods of market volatility – accompanied by unavailability of objective prices, decreased tolerance for pricing discrepancies and by the change in the operating procedures of certain counterparties – the incidence of collateral disputes increases significantly.

As a part of the drive to address perceived weaknesses in the derivatives markets, on September 30, 2009, after many months in development, ISDA published the final 2009 Collateral Dispute Resolution Procedure (the “DR Procedure”). Draft Guidelines for Implementation of the DR Procedure (the “Implementation Guidelines”) were published the same day. Drafted by the ISDA Collateral Committee in consultation with the ISDA Product Steering Committee and other industry associations in response to a request made by the Federal Reserve Bank of New York on behalf of a broader group of financial regulators, the DR Procedure is designed to (i) identify the causes of collateral disputes in a timely manner, (ii) ensure the movement of as much collateral as can be mutually agreed as soon as possible, (iii) provide market participants with a flexible range of dispute resolution methods within their respective risk tolerance levels, (iv) create a predictable and consistent basis for resolving disputes throughout the marketplace, and (v) eliminate delays and uncertainty which ultimately increases risk resulting from unresolved disputes.

If one party to a Credit Support Annex reasonably disputes (i) the other party’s calculation of a Delivery Amount or a Return Amount or (ii) the Value of any transfer of Eligible Credit Support or Equivalent Credit Support, and the other party chooses not to waive its demand in whole or to the extent of the disputed amount, the DR Procedure will be invoked. It should be noted that the 1994 Credit Support Annex according to New York Law, unlike the 1995 Credit Support Annex According to English Law, does not include the qualifier “reasonably” in connection with the disputation of a margin call. Therefore, the DR Procedure modifies the triggering of the right to dispute under the New York law version in this respect.

In view of the significant changes in the internal policy and governance of financial firms, and the required complex process and infrastructure changes, the Implementation Guidelines provide that the DR Procedure will be implemented in stages. An Experimental Pilot Program is set to run from mid-October to mid-December of this year where firms have volunteered to run the procedure with respect to actual disputes in order to identify obvious deficiencies so that ISDA will be able to correct them. A Trial Period, where it will be mandatory for certain major dealers (the “Fed 15”) to implement the procedure and other firms will participate on a voluntary basis, will implement the DR Procedure in a non-exclusive manner. In other words, the parties will use their existing contractual documentation as a back up should they run into problems implementing the DR Procedure. The Trial Period is currently scheduled to run from January 15 – June 15, 2010. From July 15, 2010 onward, the DR Procedure is to be adopted by the industry as a whole on an exclusive basis. A protocol mechanism similar to other ISDA protocols is being considered but for the beginning stages of implementation a pair of counterparties wishing to adopt the DR Procedure will execute an amendment to their existing Credit Support Annex. ISDA has provided sample draft language for such amendments in an annex to the DR Procedure.

The purpose of this note is to outline the ISDA-proposed steps for the resolution of disputed collateral calls, with the caveat that such procedure will be subject to further fine-tuning and amendment as a result of the trial period.

Step 1- Preliminary Collateralization

The first step of the DR Procedure (“Preliminary Collateralization”), is designed to allow any undisputed amount of collateral to be moved by the close of business on the Settlement Day following the day that a dispute is initiated (the day on which a collateral demand is disputed, is referenced in the DR Procedure as “Day D”)¹.

This step will not address scenarios where the parties are deadlocked, that is, calling for collateral to be delivered from each other simultaneously. In that case, no collateral will be moved, however, the DR Procedure will continue to apply as the parties move on to the next step.

Step 2- Portfolio Reconciliation

By the end of the day following Preliminary Collateralization, the parties must complete the second step of the DR Procedure, (“Portfolio Reconciliation”). This exchange of trade details is mandated for both parties. By exchanging and reconciling portfolio information, the parties will determine

¹ Note that Section 2.1(ii) of the DR Procedure provides transfer shall be initiated not later than the close of business on the Settlement Day following Day D but the timing chart provides it is to be finished on Day D.

whether or not the disputed trades have a difference greater than the Tolerance level². All trades with a difference greater than the Tolerance level and any unmatched trades (trades where collateral assets, balances or related interest amounts or valuations are in dispute) will automatically be deemed “Trades Under Investigation” and move on to the next step of the DR Procedure (“Consultation”) along with any trades with a difference less than the Tolerance level that either party elects to deem Trades Under Investigation³.

Step 3- Consultation and Informal Dispute Resolution

Although the ISDA Credit Support Annex in its current form provides that disputing parties will consult with each other in an attempt to resolve disputes, the parameters surrounding what the parties need to do to “consult with each other” are currently undefined. The Consultation step of the DR Procedure will attempt to remedy this uncertainty. While the language of the DR Procedure does not stipulate mandated activities, it does require parties to apply a non-binding list of activities to review all Transactions Under Investigation and determines the appropriate level of personnel to participate in these activities. If disputed issues that exist entering into Consultation have not been resolved within the standard timing or extended timing for this step, the parties to the related transactions will discuss at the appropriately senior level which of the alternative methods (the “Informal Resolution Methods”) outlined in the Informal Dispute Resolution step of the DR Procedure, if any, they will mutually elect to follow.

If a dispute exists but no trades have been designated Trades Under Investigation (for example if a large portfolio contains trades with individually small differences that aggregate to a disputable large difference), the parties may agree to move on to the Consultation step or proceed directly to the fourth step of the DR Procedure (“Informal Dispute Resolution”).

The Informal Dispute Resolution step is comprised of four alternative Informal Resolution Methods and the parties may elect one or more of these methods.

- i. If the parties choose the first method (“Temporary Collateral Adjustment”), the Delivery Amount or the Return Amount under the Credit Support Annex will be adjusted to a level where the parties can agree, either by using the Mid Point Collateral Amount Methodology or the Spread Based Moderation Methodology (each as defined in annexes to the DR Procedure) or by any other agreed upon methodology whereby the parties meet in the middle or one party agrees to come closer to the other party’s call.

² The tolerance level will be a standardized degree of difference set by ISDA from time to time with a risk-based deviation for different product types.

³ Either party may also elect to reduce the Tolerance to zero.

- ii. If the second method ("Common Reference Pricing") is used, each party's proprietary call would be replaced by pricing computed by some agreed upon common reference source.
- iii. The third method ("Mutually Agreed Exit Of Position"), resolves a disputed position by having the parties agree to terminate or assign both sides of a Transaction Under Investigation to an exchange or clearing house or for one or the other of the parties to privately negotiate assignment to a third party.⁴
- iv. The fourth method ("Other Resolution Method"), is a catch-all provided as a way for parties to follow the DR Procedure and choose some other dispute resolution method. These other methods could include but are not limited to a compromise in collateral requirement or re-valuation determined in some manner other than those described in the Informal Resolution Methods, a mutual agreement not to collateralize some or all of the exposure or an agreement to temporarily forbear the exercise of rights or remedies without waiving such rights.

Any Trade Under Dispute Resolution that is not resolved to the satisfaction of the parties by the end of the Informal Dispute Resolution step of the DR Procedure will proceed to the fourth step ("Formal Dispute Resolution") and be classified as a ("Transaction Under Formal Dispute Resolution").

Step 4- Formal Dispute Resolution

If all of the four methods described above do not yield results, the Formal Dispute Resolution step of the DR Procedure establishes a framework for a mandated Market Polling process to resolve disputes. Market Polling is to be accomplished in three ordered stages (such stages, "Polling Process Consultation", "Quote Gathering" and "Quote Evaluation").

Polling Process Consultation is to be accomplished two (2) Local Business Hours after it has started, unless the parties agree to alternative timing. During this stage each party will affirm whether it is acting as a Rebutting Party, a Market Making Party, or both, with respect to the Formal Dispute Resolution step. A Market Making Party, a party that can produce quotes itself or through an affiliate during the Quote Gathering stage along with quotes from third parties, must qualify as a Financial Institution that (a) regularly maintains an executable, two-sided market consisting of a simultaneous bid and offer for a traded quantity of the product in question, or in the case of illiquid instruments, is willing to make an executable, two-sided market for an extended and commercially reasonable period of time; and (b) is of Reputable Credit Quality (any entity that meets these requirements, a "Reference Independent Price Source"). If both parties qualify as Reference Independent Price Sources then each shall be designated as both a Market Making Party and a

⁴ Parties that choose the Mutually Agreed Exit Of Position method could use a variety of other exit strategies and are not limited to assignment or termination.

Rebutting Party simultaneously and if neither qualify then each will be designated a Rebutting Party and there will be no Market Making Party. During Polling Process Consultation the parties will also agree on the third party sources from which they will solicit quotes (Clearing Houses or third party Reference Independent Price Sources) and the timing for stating Quotes and may also exercise the Limited Right of Challenge provided for in the DR Procedure to challenge any source’s qualifications as a Reference Independent Price Source.

The Quote Gathering Period is to be accomplished within eight (8) Local Business Hours after it begins, unless the parties agree to alternative timing (trans-continental trades will be allowed an extra eight (8) Local Business Hours). Each party will submit its Quotes during this period, whether provided by the Market Making Party (each, a “Market Maker Quote”) or a qualified third party (each, a “Reference Quote”).

The Quote Evaluation Stage is to be accomplished as rapidly as possible but in any event in less than eight (8) Local Business Hours. All of the Quotes either made or gathered by either party must be disclosed to the other. Each quote that can be described as (a) two-way, firm, executable; (b) two-way, indicative; or (c) mid-market indicative will be considered part of the process and any other quotes will be discarded. The collated Quotes are then evaluated based on their source and whether the parties are Market Making Parties or Rebutting Parties or both and some mid-point between average bid and the average offer is determined as the Result. The DR Procedure provides responsibilities and standards to be applied to participating Quote providers.

Timing

In general, the timing standards set forth in the DR Procedure are deliberately fast-paced in order to address situations where credit distress of one of the parties is at issue. In situations where credit distress is not present, parties can agree to extensions of these standards. The prescribed timing is set out below:

	Standard Timing		Extended Timing	
	Start	End	Start	End
Preliminary Collateralization	D	D	D	D
Portfolio Reconciliation	D	D+1	D	D+1
Consultation/Informal Dispute Resolution			D+2	D+7
Formal Dispute Resolution	D+1	D+3	D+7	D+9

The steps in the DR Procedure can also be accelerated or bypassed by consent of both parties or by unilateral declaration by either party up to Formal Dispute Resolution which must then be completed. Acceleration may be appropriate where transactions have already undergone the type of investigation present in the earlier steps or in high credit situations where a reduced timeline is necessary to mitigate risk. If either party fails to perform any step of the DR Procedure by the prescribed time periods or within the time periods otherwise agreed between the parties and does not remedy such failure within two (2) Local Business Hours after receiving written notice of such failure, their calculation or disputation, as applicable, of the Delivery Amount or Return Amount shall be void and the calculation or opinion of the other party shall stand as the Result.

Longevity of Results

While the results achieved through the DR Procedure are temporary in nature, they do have potential applications to future disputes. Unless otherwise provided, the results will be used to compute margin demands between parties until relevant markets move or some additional transparency of fair value develops, however each party to a Credit Support Annex has the right to terminate the continued use of the results at its discretion.

Conclusion

The text of the DR Procedure may be revised over the course of the stages of implementation to address any findings that arise and will be re-published by ISDA accordingly. The DR Procedure, if successfully implemented, will improve the collateralization process (and therefore counterparty risk management) by requiring counterparties to exchange portfolio information, by introducing consistent market practice regarding consultation, by involving market makers in the polling process and by providing for “longevity” to the results of the DR Procedure, which will prevent the need to repeat the procedure daily on sustained disputes.

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