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July 15, 2009

Mr. Theo Lubke
OTC Derivatives Supervisors Group
Federal Reserve Bank of New York
33 Liberty Street, 10F
New York, NY 10045

Dear Mr. Lubke,

On June 2, 2009 we published the 'Outline of the 2009 ISDA Protocol for Resolution of Disputed Collateral Calls' for public commentary. This formed the first phase of the commitment made by the derivatives industry in relation to improving margin call dispute resolution. In this letter, we address the second phase of our dispute resolution commitment which adds proposals to address the more complex, structured or illiquid transactions that cause a margin call to be disputed.

ISDA will publish this paper on its website and administer a public comment period which will remain open until August 7, 2009

The next phase of our work will be to deliver a comprehensive final protocol document plus an implementation plan. We reaffirm our intention to deliver this by the end of September.

We would be delighted to discuss any aspect of this work in more detail, and will also continue to keep your staff updated with progress on future deliverables.

Yours sincerely,

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Michael Clarke
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The contents of this letter and the attached proposal have been developed by the ISDA Collateral Committee, which includes representatives of the following firms and industry associations. It should be noted that given the complex and wide ranging nature of the topics covered in these documents, individual firms may choose to submit additional comments as they consider appropriate.

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Outline of the 2009 ISDA Protocol for Resolution of Disputed Collateral Calls

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*This document is **version 2** of the outline of the proposed 2009 ISDA Protocol for Resolution of Disputed Collateral calls and is being published for the purpose of soliciting comment from interested parties, in order to assist in the preparation of a final version for adoption. Details described herein are subject to amendment.*

***Version 2** brings together what were previously Phase 1 and Phase 2 of the Dispute Resolution proposal to provide a comprehensive document.*

The Phase 1 Commentary to the 2009 ISDA Protocol for Resolution of Disputed Collateral Calls (the “Commentary”), has already been published. The Phase 2 Commentary has been included as footnotes in this document and both should be read together with the DR Protocol.

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1 Introduction

- 1.1** At the direction of ISDA's Board of Directors, the ISDA Collateral Committee in consultation with the ISDA Product Steering Committees and other industry associations has developed a proposal for the 2009 ISDA Protocol for Resolution of Disputed Collateral Calls (the "DR Protocol")
- 1.2** The purpose of this proposal is to provide a dispute resolution process for collateralized OTC derivatives that:
- i) Achieves timely identification of the root causes of disputed collateral calls
 - ii) Ensures the prompt movement of as much collateral as the parties can mutually agree
 - iii) Provides the parties with a flexible range of methods to narrow and/or resolve their dispute to be consistent with their risk tolerance
 - iv) Creates consistent and predictable process, timing and behavior in case of disputes across the market
 - v) Eliminates present uncertainties and delays that increase risk for the parties
- 1.3** When operated in conjunction with enhanced regulatory disclosure in the case of hard-to-resolve disputes that we anticipate the supervisory community will request, the DR Protocol will bring to the market improved structure, transparency and probability that resolution of differences is ultimately effective.
- 1.4** The proposal provides for a phased implementation of the DR Protocol that would permit significantly improved market. Phase 1 of the DR Protocol (published June 2, 2009 for comment) described the overarching framework for resolution of disputed margin calls. This Version 2 document (published July 15, 2009 for comment) builds upon the Phase 1 paper and provides additional methods for dealing with disputes involving complex, structured or illiquid transactions.
- 1.5** When the DR Protocol has been thoroughly reviewed by market participants and subjected to a comment period, it is anticipated that final documentation will be drafted in accordance with the results of that review process.
- 1.6** The comment period for this document is now open and closes on August 7, 2009. Comments should be directed to Julian Day and Nichole Framularo at ISDA (jday@isda.org, nframularo@isda.org).
- 1.7** Please note that Version 2 generally does not yet incorporate comments received during the public comment period for Phase 1 that occurred during June. These comments have been preserved and all comments will be considered in due course. Accordingly, comments made during the Phase 1 public comment period need not be repeated since they will be combined with comments received on this version of the document and assessed together.
- 1.8** ISDA thanks all of its members and others who have contributed to the development of this proposal or who have provided comments on it.

2 General Terms and Conditions

- 2.1** Commercial Discretion of the Counterparties. At all times the parties retain the ability to mutually contract as they wish subject to applicable law, and may exercise this right to cause a different timing or method of resolution from that set forth in the DR Protocol.
- 2.2** No Obligation to Secure Credit Risk. Unless otherwise established by contract, official rules or statute, the parties to a privately-negotiated over-the-counter derivative transaction are not under an obligation to secure the associated credit risk of that transaction by means of collateral or other methods if they agree mutually to do otherwise.
- 2.3** Reservation of Rights Under Applicable Laws and Contracts. Both parties expressly reserve all rights that they may have under any contracts between them or pursuant to applicable laws, including but not limited to rights to issue notices of events of default, to exercise of termination provisions or to exercise other rights or

remedies. For the avoidance of doubt, nothing in this DR Protocol shall amend, limit, delay, stay or otherwise amend such rights¹.

- 2.4** Timing. The DR Protocol sets forth specified Standard Timings for each step. The Standard Timings are calibrated to a situation where credit distress is evident with respect to one or both parties. In these circumstances it will be desirable to execute the DR Protocol as expeditiously as possible. The Standard Timings are therefore deliberately tight. This is because it would be unhelpful to start with more extended timeframes and then expect the parties to be attempting to agree reduced timeframes during a period of credit distress. It is more conservative to start with short timeframes and permit them to be extended where credit distress is not apparent. In circumstances where there are no immediate credit concerns and there are operational or other extenuating reasons, and both parties concur, they may adopt longer timeframes to allow operational processes to be resourced in a commercially reasonable manner. It is also noted that the time required for each step in the DR Protocol may properly vary according to the size and complexity of the portfolio between the parties. Therefore the DR Protocol is based on the idea of Standard Timings which can be varied in certain circumstances. These circumstances may include (but are not limited to):
- (a) Disputed collateral calls caused by transaction differences that have already been thoroughly investigated, and may not therefore require the full Standard Timing to progress through the DR Protocol
 - (b) Situations where especially complex transactions are being progressed through the DR Protocol but require additional time for investigation
 - (c) High credit stress situations in which an expedited approach is desirable to mitigate risk
 - (d) Unstressed credit situations in which an extended approach is desirable to manage resources and costs in a commercially reasonable manner.

Accordingly, the following timing adjustments² are permitted:

- i) Acceleration. Any step in the DR Protocol may be accelerated or bypassed either (a) by mutual consent of the parties or (b) by unilateral declaration of either party up to Step 4b which must then be completed.
- ii) Extension. Any step in the DR Protocol may be extended by mutual consent of the parties if they are actively engaged in the process and there is a reasonable expectation that resolution will result, subject to a maximum limit of 30 days³ for the overall process. For convenience and consistency across the market, the concept of Extended Timings may be used by the parties⁴.
- iii) Extended Timings. To avoid fragmentation of behaviours in the market, a pre-defined set of Extended Timings may be elected by the parties who exercise the option for extension. This will increase the Standard Timing for each step in the DR Protocol as follows:

¹ This protocol is meant to guide professional behavior rather than remove any right a party has to deliver a notice of default at any time. If one party feels that it is appropriate to deliver a notice of default at any point during the dispute resolution process, they are legally entitled to do so.

² The rationale behind the timings in the DR Protocol is the following. The Standard Timing is selected to be as short as possible to reflect the desirable timeframe parties would like to follow during a credit event. Acceleration by mutual consent is designed to address situations where the parties have a good existing analysis of the portfolio differences and can proceed through the DR Protocol in an even shorter timeframe. Acceleration by unilateral action is designed to address situations of imminent credit danger. Extension by mutual consent is designed to address situations where the parties need more time to investigate particularly complex situations. The Extended Timings provided are meant to be operationally feasible, if demanding, but not so long as to introduce excessive additional risk intervals that would adversely impact risk computations. Finally, the overall limit of 30 days is designed to strike a balance between permitting enough time for the parties to exhaust all reasonable avenues of resolution and the desire of supervisors to be timely notified of intractable disputes.

³ If the parties reach T+30 without resolution, it is expected that they shall continue to engage in efforts to secure a resolution – i.e. it is not the case that on day 31 all discussions cease.

⁴ Extensions need not follow the Extended Timings provision - they may be of any mutually agreed length subject to overall time limits. The concept of Extended Timings is simply to promote coherent practice among market participants where suitable.

	Standard Timings [3 days]		Extended Timings [9 days]	
	Start	End	Start	End
Step 1: Preliminary Collateralization	T	T	T	T
Step 2: Portfolio Reconciliation	T	T+1	T	T+1
Step 3: Consultation			T+2	T+4
Step 4a: Mutual Informal Dispute Resolution			T+5	T+7
Step 4b: Formal Dispute Resolution	T+1	T+2	T+8	T+8

Extended Timings will be invoked at the suggestion of either party and adopted upon the consent of the other party, not unreasonably to be withheld.

- 2.5 Timings are expressed as a number of elapsed business days after day T.
- 2.6 Mutual Consent. Where the DR Protocol calls for mutual consent, it is anticipated that this would be given orally⁵ or via email. It is not intended that the obtaining of mutual consent be a laborious, time consuming or delaying process.
- 2.7 Failure to Perform. If a party fails to perform the actions required in each step of the DR Protocol by the prescribed times (Standard Timings, Extended Timings or otherwise modified times, as applicable), the other party can unilaterally decide to accelerate to the next step.
- 2.8 Ability to Perform Portfolio Reconciliations. To be eligible to sign up for the DR Protocol, a party must have the necessary technical and human resources capability to perform portfolio reconciliations whenever required under the protocol, including the ability to appropriately investigate the results of such reconciliations.

3 Structure of the DR Protocol

- 3.1 The DR Protocol consists of 4 Steps. The purpose of Step 1 is to ensure that as soon as possible after a collateral call is disputed, the maximum amount of collateral that the parties can agree is not in dispute is moved so as to ensure the secured party is protected as far as possible in the circumstances. The purpose of Steps 2 and 3 is to analyze the causes of the dispute and to isolate those transactions or other factors under the collateral agreement that may need resolution. These steps also provide an opportunity for the parties to administratively resolve any causes of dispute that are due to oversight, error or other readily corrected cause. The purpose of Step 4 is to provide for a range of alternate methods to resolve items in dispute, including both informal, mutual methods of resolution and more formal approaches.
- 3.2 T is the day on which a collateral call by Party A is disputed by Party B. In this situation, Party A having been disputed may either (a) waive its call in whole or part, or (b) invoke the dispute resolution process below. The clock starts ticking from the point of invocation of the process. In the event that both parties are making a collateral call on the other, and each is disputing the call made on it, then either party may invoke the DR Protocol. If both parties invoke the DR Protocol then it shall operate in a single instance (since it is agnostic as to which party is calling and which disputing).
- 3.3 Step 1 : Preliminary Collateralization
 - i) Step 1 starts and finishes⁶ on date T
 - ii) The parties move collateral based on the Undisputed Collateral Amount Methodology (see section 4.1 (v))
- 3.4 Step 2 : Portfolio Reconciliation
 - i) The parties exchange portfolio details and perform a portfolio reconciliation⁷

⁵ It is recommended that recorded lines be used for this purpose in case of any controversy.

⁶ Note that although Step 1 is completed on T, it may take additional days for collateral moved as the Undisputed Collateral Amount to actually settle, which takes place in accordance with the normal timings under the agreement and market conventions.

⁷ A portfolio reconciliation may entail a full line by line, field by field matching process performed using technological means such as a portfolio reconciliation service or technology engine, or may be any other method that the parties agree accomplishes the same result of identifying and isolating the items contributing most significantly to the dispute.

- ii) Trades with difference greater than the Tolerance level (see 3.5) and all unmatched trades must be ring-fenced as Transactions Under Investigation and proceed to Step 3.
- iii) In addition, trades with difference less than the Tolerance level can be deemed Transactions Under Investigation by either party and proceed to Step 3.

3.5 Tolerance is a standardized degree of difference that will still be considered “matched” for the purpose of collateralized portfolio reconciliation. It is set by ISDA from time to time. Currently the Tolerance is agreed as \$10mm plus a risk-based deviation for different product types⁸. Use of the Tolerance to select Transactions Under Investigation ensures that excessively large differences cannot remain uninvestigated; note that either party may require that specific trades with differences below the Tolerance be added to the list of Transactions Under Investigation.

3.6 Step 3 : Consultation

- i) For Transactions Under Investigation, both parties will have their internal trading desk or financial controllers confirm their marks.
- ii) For any transactions internally re-affirmed above, desk-to-desk conversation between the counterparties will take place as needed to resolve valuation differences
- iii) Both parties will collaborate to resolve any unmatched (alleged) trades; the alleging party must provide the confirmation and both trade references or the alleged common reference for centrally registered trades.
- iv) Recently executed trades yet to be confirmed are excluded from the requirement to resolve alleged trades during Step 3 for a period of 5 days after execution⁹
- v) Any Transactions Under Investigation, excluding unmatched trades, not resolved within the Standard Timings or Extended Timings if applicable for Step 3 become Trades Under Dispute Resolution and proceed to Step 4

3.7 Unmatched trades will not be susceptible to resolution by the methods available in Step 4, thus they are excluded. However, notwithstanding the Recent Trades exclusion (see section 3.6 (iv)) the parties must determine the existence (or not) of an unmatched trade via the normal procedures already used in the market within the window for Step 3.

3.8 Step 4 : Dispute Resolution – Part 4a Mutual Informal Dispute Resolution

- i) The parties may mutually elect one of the following methods to resolve:
 - (a) 4a-1 Temporary Collateral Adjustment
 - (b) 4a-2 Use of Common Reference Pricing
 - (c) 4a-3 Mutually Agreed Exit of Position
 - (d) 4a-4 Other Resolution Method
- ii) After application of one or more of these methods, any Trades Under Dispute Resolution with remaining differences not resolved to the mutual satisfaction of the parties proceed to 4b below.

3.9 Step 4 : Dispute Resolution – Part 4b Formal Dispute Resolution

- i) After the parties have exhausted the above remedies¹⁰, they are mandated to attempt Market Polling which consists of 2 stages:
 - (a) Stage 1 - Quote Gathering

⁸ Tolerance levels for the purpose of portfolio reconciliation and use in the DR Protocol are reviewed from time to time by a sub-committee of the ISDA Collateral Committee. Currently the level used between the Fed 16 dealers is \$10mm plus a risk-based deviation which varies by product type. It has been suggested that a lower level may be appropriate in non dealer-to-dealer situations, and this will be considered during the implementation phase of the DR Protocol.

⁹ This is because it is undesirable to initiate an additional process to resolve these differences in parallel to the existing confirmation process designed to achieve the same objective. The risk of this exclusion is limited due to its brevity and the fact that most (but not all) trades are done close to par and so contribute little net MTM impact to the margin call. Note that the parties are entirely free to accelerate their normal confirmation process and to expedite confirmation of these trades.

¹⁰ Or alternatively upon acceleration to this point in the process, pursuant to the provisions of section 2.4

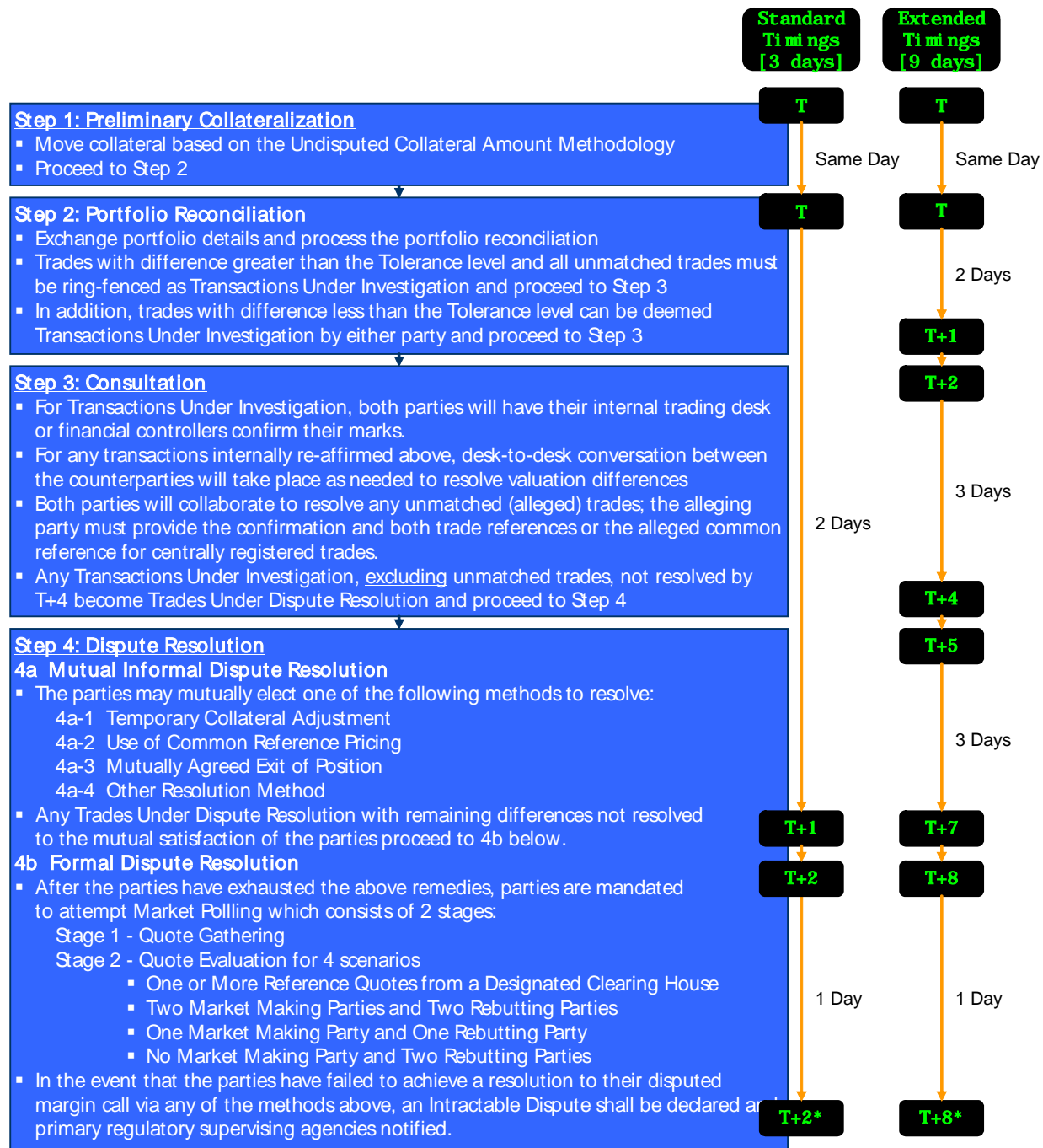
(b) Stage 2 - Quote Evaluation for 4 scenarios

1. One or More Reference Quotes from a Designated Clearing House
2. Two Market Making Parties and Two Rebutting Parties
3. One Market Making Party and One Rebutting Party
4. No Market Making Party and Two Rebutting Parties

3.10 In the event that the parties have failed to achieve a resolution to their disputed margin call via any of the methods above, an Intractable Dispute shall be declared and primary regulatory supervising agencies notified.

3.11 Notices : When the parties determine the subsets of Transactions Under Investigation (at the end of Step 2) and Transactions Under Dispute Resolution (at the end of Step 3) they must document this by either exchanging notices, or by use of a common repository for such information, or by such other means as they may agree, all in sufficient detail to permit unambiguous identification of the subject transactions in each case.

3.12 The diagram below illustrates the DR Protocol:



* If the geographic locations of the parties and/or the relevant markets in which prices for the trade(s) in question are trans-continentially dispersed, the time allowed for Quote Gathering is extended by one additional business day (e.g. Under Standard Timings, Step 4b will complete on T+3 instead of T+2)

4 Detail of Steps 1, 2, and 3

4.1 Step 1 : Preliminary Collateralization

- i) For a collateral call that is disputed on day T the calling party may either (a) waive its collateral call in whole or part or (b) invoke the following Dispute Resolution process.
- ii) Depending on the terms of the CSA, a collateral call that is disputed on day T may have been issued on T or T-1.
- iii) On day T, the parties agree any Undisputed Collateral Amount (“UCA”). This must be settled by the relevant party in accordance with the terms of the CSA.
- iv) If both parties are calling each other simultaneously, there is no UCA.
- v) The UCA Methodology is implemented by moving collateral based on the largest amount that would be undisputed by one party calculated as follows:

	Party A	Party B	Undisputed Collateral Amount	Resulting Collateral Movement
	X Call	Y Call	$M = \text{Min} (X , Y)$	
Both parties counter-call – there is no UCA	10	20	-	No collateral movement
Both parties counter-call same amount	20	20	-	No collateral movement
B calls, A partially agrees	-10	20	-10	Party A pays Party B: 10
A calls, B agrees to pay 10 as less than expected call	10	-20	10	Party B pays Party A: 10
In practice neither calls	-10	-20	-	N/A

+ = Call made on other party	+ = Movement due from B to A
- = Call expected to be received from other party	- = Movement due from A to B

4.2 Step 2 : Portfolio Reconciliation

- i) On T the parties are required to exchange portfolio information in electronic form. This includes, if in dispute, collateral asset, balance, interest amounts and valuation information.
- ii) Portfolio information from the parties is reconciled (electronically or by other means as the parties consider appropriate) to identify trade or collateral asset level valuation differences.
- iii) Using the appropriate Tolerance for each product type (as published by ISDA from time to time) the transactions with differences exceeding the Tolerance are identified and designated as Transactions Under Investigation. Either party may additionally designate other transactions whose differences do not exceed the Tolerance as Transactions Under Investigation or reduce the Tolerance to zero. If collateral assets, balances, interest amounts or valuations are in dispute then these are designated as Transactions Under Investigation. The list of Transactions Under Investigation must be identified within the Standard Timings or Extended Timings if applicable for Step 2.
- iv) It is possible that a dispute exists but no trades are designated as Transactions Under Investigation (ie no trades exceed the Tolerance and the parties do not so-designate any other trades with smaller differences). This could occur if a large portfolio contains many trades with individually small differences that in aggregate lead to a large difference. In this case, the process proceeds to Step 3 for Consultation, but this will likely be truncated and the parties may proceed to Step 4a directly.

4.3 Step 3 : Consultation

- i) The parties are required to internally review all Transactions Under Investigation to verify their valuation. This may be done in whatever manner each party considers appropriate, but must include, if necessary, reference of the issue to the relevant trader or desk head¹¹.
- ii) The following actions are not binding but indicate the type of process that each party should in good faith undertake during the Consultation step:

¹¹ To ensure timeliness of investigation and response, individual firms may want to establish front-to-back investigation processes with service level commitments between internal departments.

- (a) Investigation to detect incorrect matching of trades, data errors and other artifacts causing “false positive” reconciliation results
 - (b) Review of golden records held in trade registries to assist matching trades
 - (c) Referral of transactions to desks/controllers to validate marking curves and other model parameters are updated, and to confirm that marks are fresh and valid
- iii) If anomalies are detected, recalculation of valuation and amendment of collateral calls by both parties occurs as necessary.
 - iv) Parties must consult between themselves at a trader-to-trader or desk head to desk head level to attempt to understand and resolve differences.
 - v) Each party must identify the internal owner of each Transaction Under Investigation and facilitate a timely discussion with the relevant counterparty owner, exchanging contact information as may be appropriate.
 - vi) If anomalies are detected, the relevant party must recalculate its valuation and the collateral call shall be amended as necessary.
 - (a) In the case of alleged trades or collateral assets not recognized by one party, the alleging party must provide confirmations, trade references or other supporting documentation; both parties must work to resolve differences due to alleged trades or collateral assets. These allegations must be resolved within the Standard Timings or Extended Timings if applicable for Step 3.
 - (b) All items entering Step 3 that remain unresolved within the Standard Timings or Extended Timings if applicable for Step 3 (business days) are designated as Transactions Under Dispute Resolution and move forward to Step 4a.

5 Detail of Step 4a - Mutual Informal Dispute Resolution

5.1 Method 4a-1 : Temporary Collateral Adjustment

- i) Parties may elect to use this method if both agree to do so
- ii) Objective is to agree adjustment(s) to the margin calculation in respect of certain specific transactions
- iii) Adjustments are temporary - the parties agree their longevity, which may range from 1 day to 3 months unless reviewed and mutually extended or abbreviated
- iv) Adjustments are applied to the collateral calculation, not the trade valuation. It is important to correctly characterize adjustments as temporary and applying to the collateral calculation not the valuation of the underlying transaction(s)
- v) Therefore the parties specifically acknowledge that Temporary Collateral Adjustments are not intended to amend the value attributed to any transaction by either party.
- vi) Adjustment may follow the Mid Point Collateral Amount Methodology (equivalent to splitting the difference) or may be asymmetrical and thus yield a result closer to the opinion of one party, if both agree.
- vii) This method specifically allows that each party to a dispute may receive only partial satisfaction of their claim, and that for the balance of the difference they may in effect agree to differ. This is entirely consistent with the idea that parties be free to transact on a fully, partially or un-collateralized basis in the privately negotiated derivatives market, within the boundaries of their prudential risk appetites.

5.2 Method 4a-2 : Common Reference Pricing

- i) Parties may elect to use this method if both agree to do so
- ii) Common Reference Sources might include prices computed by clearing houses (e.g. TCC) but potentially also other sources provided by vendors.
- iii) The parties mutually agree the source(s) to be used.
- iv) Prices from these sources would be used instead of counterparties' proprietary mark-to-market calculations for the sole purpose of computing disputed collateral calls.

- v) The dispute would be avoided, since the collateral call would be re-computed based on common pricing¹².

5.3 Method 4a-3 : Mutually Agreed Exit Of Position

- i) Parties may elect to use this method if both agree to do so
- ii) The parties may mutually agree to exit a disputed position, via several possible mechanisms.
- iii) These include, but are not limited to:
 - (a) Terminating one or more transactions, at a mutually agreed price. Clearly this would imply some agreement between the parties as to the price at which the termination would be executed. This may appear strange if the parties were unable to agree a price for collateralization purposes, but sometimes they may be more willing to agree an exit price and have certainty than have an on-going series of open-ended margin disputes over time.
 - (b) Assignment of the position by either party to a third party willing to take the trade, at a privately negotiated price between assignee and assignor.
 - (c) Assignment of the position by both parties to an exchange or clearing house for which the position is eligible, at a price set by the clearing house.

5.4 Method 4a-4 : Other Resolution Method

- i) Parties may elect to use this method if both agree to do so
- ii) Consistent with the ability of the parties to contract subject to applicable law, and the inherent characteristics and conventions of the privately negotiated derivatives market, it is explicitly reserved that the parties may mutually agree any other method of resolution of a dispute existing between them.
- iii) This includes, but is not limited to:
 - (a) A compromise in the collateral requirement due, mutually determined in some other manner
 - (b) A valuation mutually determined in some other manner
 - (c) A mutual agreement to not collateralize some or all of the exposure between the parties, including exposure whose amount is uncertain or subject to dispute
 - (d) A mutual agreement to disagree and to temporarily forbear exercise of other rights or remedies without prejudice to those rights

6 Detail of Step 4b - Formal Dispute Resolution

6.1 Foundation

- i) After the parties have exhausted the above remedies in Step 4a without accomplishing a resolution of their dispute¹³, they are mandated to attempt the resolution process set forth in Step 4b.
- ii) Step 4b is intended to produce a market-based determination where possible of the value to be ascribed to trades which are causing a margin call to be disputed. It is expressly understood that while the result is an approximation for the calculations that would occur in the event of a termination under the ISDA Master Agreement between the parties, it may not be the same as the results that would occur from the application of the full Market Quotation, Loss or Close Out methods that would apply in the event of termination.
- iii) It is required that Step 4b shall be conducted in a collaborative manner by the parties to the dispute, with the goal of seeking an objective, market-based determination of the collateral amount (if any) to be moved between the parties, consistent with the principles below. The parties are required to cooperate with one another to conduct the procedures in Step 4b in an expedited, transparent manner.
- iv) Step 4b is based on two key principles of informational precedence:

¹² Arguably, such an approach does not avoid disputes, but rather recharacterizes them from being a difference between the values alleged by two counterparties (A and B) to instead being two independent differences, first between A and the Common Reference Source, and second between B and the Common Reference Source.

¹³ Or alternatively upon acceleration to this point in the process, pursuant to the provisions of section 2.4

- (a) Price Discovery - As a general principle, designated clearing houses will have transparency to the greatest number and diversity of most recent market transactions; firms that are market makers will have transparency to a wide number and diversity of recent market transactions; other firms will have more limited market transparency based on any transactions they have executed. All firms may have access to price quotes (firm and/or indicative) from market makers, which may be useful sources of supplemental or rebuttal information. It is also noted that pricing and practice within designated clearing houses and market makers are subject to applicable regulatory regimes.
 - (b) Price Firmness - As a general principle, two-way, firm executable prices will be more likely to be accurate than two-way indicative prices, one-way indicative prices or mid-market indicative prices.
- v) Therefore:
- (a) Prices stated by clearing houses are presumptively correct; for the purpose of the DR Protocol this presumption is non-rebuttable.
 - (b) Prices stated by market makers have informational value and prices stated on a two-way, firm, executable basis have particularly high informational value for the purpose of dispute resolution¹⁴, subject to rebuttal by as set out below.
 - (c) Prices from whatever source are applied in the following order of priority:
 - 1. prices quoted by designated clearing houses first; if none then
 - 2. two-way, firm, executable prices next^{15,16}; if none then
 - 3. indicative prices (two-way and mid-market).
- vi) Dispute Resolution under Step 4b shall take place as follows:
- (a) If one of the two disputing parties is a designated clearing house then its value determination shall be definitive and not subject to rebuttal. Collateral shall be moved based on this value in accordance with the terms of the CSA and any other contractual documentation governing the credit relationship between the parties.
 - (b) If both of the disputing parties are Reference Market-makers¹⁷ then the Market Polling process described below shall take place and each party shall be both a Market Making Party and a Rebutting Party simultaneously.
 - (c) If one of the disputing parties is a Reference Market-maker then the Market Polling process described below shall take place and the Reference Market-maker shall be a Market Making Party and the other party shall be a Rebutting Party.
 - (d) If neither of the disputing parties is a Reference Market-maker then the Market Polling process described below shall take place and each party shall be a Rebutting Party; in this case there is no Market Making Party.

¹⁴ The fact that a firm is willing to make a two-way, firm, executable price should be accorded special significance when compared to prices quoted on a lesser basis because of the implied willingness to commit the firm's risk appetite and capital, and the high standards of internal management oversight, audit and supervisory review which underpin the making of markets by firms.

¹⁵ One of the most significant market practice changes in the DR Protocol compared to historical market practice is the change to focus on two-way, firm, executable prices. This is intended to prevent potential abuse of the process by firms that may be tempted to give overly-aggressive or overly-conservative prices during any kind of polling process, safe in the knowledge that they will never be asked to trade at those levels. It should also increase the attention paid by desks to pricing for market polls, and the seniority of review and approval of the prices quoted. It is expected that the focus on two-way firm, executable prices with commercially reasonable bid/ask spreads will encourage firms to continue to make markets in products that are becoming less liquid because this will support the essential business of marking-to-market existing positions and obtaining settlement of collateral calls - both key to effective risk management and efficiently operating derivative markets.

¹⁶ In rare circumstances it may be that one-way, firm, executable prices can be observed in the market, for example from an asset manager bidding on a less liquid asset. Although not specifically considered further in this document, it is noted that consistent with the provisions of section 2.1 the parties are free to agree mutually that these inputs shall be included in the Market Polling process to augment the pool of available quotes.

¹⁷ "Reference Market-maker" [term subject to technical definition forthcoming]

- (e) If none of the foregoing steps produces a result, the Intractable Dispute Disclosure process shall apply.

6.2 Market Polling

- i) The Market Polling process requires each party to act as a Market Making Party or a Rebutting Party or both.
- ii) It consists of two stages to be followed sequentially:
 - (a) Stage 1 - Quote Gathering, in which:
 1. Each Market Making Party will submit a two-way, firm, executable price for a traded quantity of the product(s) in question, which must bracket the mid-market level employed by that party in its approximately contemporaneous margin calculation, each a "Market Maker Quote".¹⁸ The Market Making Party will use commercially reasonable efforts to obtain prices for the product from designated clearing houses or Reference Market-makers (other than its own affiliates or a Reference Market-maker who is also the other disputing party or affiliated with the other disputing party) each a "Reference Quote".
 2. Each Rebutting Party will use commercially reasonable efforts to obtain prices from designated clearing houses or Reference Market-makers (other than its own affiliates or a Reference Market-maker who is also the other disputing party or affiliated with the other disputing party), each also a "Reference Quote".
 - (b) Stage 2 - Quote Evaluation, in which the various inputs obtained in Stage 1 are reviewed according to certain rules that will determine which of them are to be used to calculate the value for use in the margin computation; collateral is moved accordingly.

6.3 Stage 1 - Quote Gathering

- i) The Quote Gathering Period starts when the parties agree to commence Step 4b or one of the parties unilaterally accelerates to Step 4b as permitted under the overall DR Protocol.
- ii) The Quote Gathering Period lasts for one business day, or such shorter period as the parties may agree if further time would likely not yield any additional inputs. If the geographic locations of the parties and/or the relevant markets in which prices for the trade(s) in question will be determined are trans-continentially dispersed, the time allowed for Quote Gathering is extended by one additional business day¹⁹.
- iii) During the Quote Gathering Period, each party will state its Market Maker Quote and/or obtain Reference Quote(s) as appropriate to the role(s) in which it acts.
- iv) Reference Quotes generally must be obtained from designated clearing houses or Reference Market-makers, however if both parties consent they may mutually agree alternative sources from which Reference Quotes will be obtained.
- v) All quotes need to be evidenced in writing, and must state any limitations as to their validity, including but not limited to the date and time as of which the quote was valid, the size for which the quote was valid, any relevant benchmark levels in the market which were used in determining the quote and upon which the quote is conditioned.
- vi) Where two-way quotes are given, the spread must be commercially reasonable for the product and market conditions at the time, and consistent with spreads applied to quotes given for other similar products.

¹⁸ According to 6.1(vi) any firm that is a Reference Market-maker is presumptively a Market Making Party, and under 6.2(ii)(a)(1) they are obliged to give a Market Maker Quote. This creates an affirmative obligation for a party to the dispute that holds themselves out to be a Reference Market-maker to make a two-way price, which should tend to improve the quality of marking practice and price transparency in the market. If a party to the dispute that is a Reference Market-maker declines to give a Market Maker Quote, then for the purpose of the DR Protocol for the margin call in question, they shall be deemed to be a Rebutting Party and not a Market Making Party.

¹⁹ Note that pursuant to the provisions of section 2.4 it is possible for the parties to mutually agree a longer period of time for Quote Gathering. This might be appropriate in the case of complex, structured transactions that may require longer for other dealers to evaluate, in a circumstance where there is no immediate credit concern and the parties can mutually agree a longer timeframe.

- vii) Where two-way quotes are given, they must be for commercially reasonable size consistent with the size of the position that is subject to dispute, unless the parties mutually agree to solicit quotes for some other size.
- viii) All quotes must state clearly whether they are (a) two-way, firm, executable; (b) two-way, indicative; or (c) mid-market, indicative.
- ix) Quotes that are two-way, firm, executable must be posted and maintained consistently during regular trading hours in a public venue on any date as of which such quotes are provided, with appropriate descriptive detail of the trade as would be customary for the type of trade in question; posting of two-way, firm, executable prices on one or more electronic trading venues²⁰ would meet this requirement of publication.
- x) Quotes should be obtained on a credit risk neutral basis²¹ for the purpose of the DR Protocol, noting the provisions of section 6.3(x) below that provide for the factoring of credit considerations in the event that an actual transaction is contemplated on the basis of such quotes.
- xi) All sources quoting firm, executable prices for these purposes should be put on notice that they must be willing and able to stand behind the market levels they have made and to execute a transaction at those levels if called upon to do so by either of the disputing counterparties or some third party reasonably contemporaneously with the quoting of their firm, executable price. Such obligation to execute is subject to normal commercially reasonable credit due diligence (including credit risk appetite for the specific entities concerned) and credit pricing adjustment customary for the type of trade in question, and to price adjustment if the time elapsed from the making of the price quote to the point of execution is such that the underlying market has moved. For the avoidance of doubt, a firm, executable quote validly given at which any party attempts to execute but is denied based on the credit considerations noted above shall continue to be a valid firm, executable quote for the purposes of dispute resolution; the remedy of the denied party in this case would be to access the quoted price by transacting through an intermediary third party willing to transact in that capacity. The corollary is that a firm, executable quote at which any party attempts to execute but is denied for any reasons other than the credit considerations noted above shall not be a valid firm, executable quote for the purposes of dispute resolution; if the quote in question was a Market Making Quote and is thus invalidated, then pursuant to 6.2(ii)(a) the party giving that quote shall be deemed to be a Rebutting Party and not a Market Making Party for the margin call in question.
- xii) All firms who are Reference Market-makers in respect of a particular product and also subscribers to the DR Protocol shall commit that (subject to market practice, commercial reasonableness and normal market protocols concerning conflicts of interest) they will provide Reference Quotes upon request by any legitimate party reasonably engaged in resolution of a disputed margin call pursuant to the DR Protocol²².

6.4 Stage 2 - Quote Evaluation

- i) Once Quote Gathering has been completed, all of the information necessary to complete Quote Evaluation will be available and those stages should be executed as rapidly as possible, and in any event in less than one business day.
- ii) All of the quotes obtained by the parties are shared between them. Cherry-picking of quotes is not permitted.
- iii) Quotes obtained by both parties are collated into the categories specified in 6.3(vii) (a) to (c) above. Any quotes that do not clearly fit into one of these categories are discarded unless the parties agree otherwise.
- iv) The collated quotes are then evaluated as set out in the scenarios below to determine the best possible value determination given the available market inputs.

²⁰ For the avoidance of doubt, these may include organized electronic trading venues and also the use of electronic dissemination methods such as Bloomberg where such methods are customary in the market concerned.

²¹ That is, not taking account of the specific credit quality or identity of either of the disputing parties.

²² This creates an affirmative obligation, subject to the limitations described, for a party that holds itself out to be a Reference Market-maker for the product concerned to provide prices to other parties seeking Reference Quotes in connection with dispute resolution. This is designed to assure smooth operation of the market dispute resolution process by promoting the availability of prices. This commitment is only to contribute a price, not necessarily a two-way, firm, executable price.

(a) One or More Reference Quotes from a Designated Clearing House²³

Any Reference Quotes obtained from a designated clearinghouse have presumptive special status as set out in 6.1(v). These quotes only are pooled together. Market Maker Quotes and Reference Quotes on any other basis are discarded. From the pool, the remaining bids are averaged, the remaining offers are averaged, and the mid-point between the average bid and the average offer is deemed to be the mid-market value for the trade(s) in question.

(b) Two Market Making Parties and Two Rebutting Parties

The two Market Maker Quotes and any Reference Quotes that are on a two-way, firm, executable basis are pooled together. Reference Quotes on any other basis are discarded. From the pool, the remaining bids are averaged, the remaining offers are averaged, and the mid-point between the average bid and the average offer is deemed to be the mid-market value for the trade(s) in question²⁴.

(c) One Market Making Party and One Rebutting Party

The Market Maker Quote and any Reference Quotes that are on a two-way, firm, executable basis are pooled together. Reference Quotes on any other basis are discarded.

- (i) If the pool contains at least two remaining quotes²⁵, the bids are averaged, the offers are averaged, and the mid-point between the average bid and the average offer is deemed to be the mid-market value for the trade(s) in question.

The section below in blue presents some particular issues that are still under consideration and the subject of the Special Commentary appearing on the following page

- (ii) If the pool contains only the Market Maker Quote and no Reference Quotes, then the mid-point between the bid and offer of the Market Maker Quote shall be deemed to be the mid-market value for the trade(s) in question, and collateral shall be moved between the parties, subject to the following options for the Rebutting Party. If the Rebutting Party has commercially reasonable grounds to believe that the Market Maker Quote may not be reliable it may:
 1. Require the Market Making Party to certify in writing that the mid-point of its Market Maker Quote accurately reflects the level at which it is marking the transaction for purposes of its books and records²⁶.
 2. Execute a transaction at the stated bid or offer contained in the Market Maker Quote, consistent with 6.3(x)²⁷.
 3. Express its own two-way, firm, executable quote which must be presented via another Reference Market-maker to the Market Making Party, in which case (a) that level will be deemed to be a Reference Quote and processed in accordance with 6.4(iv)(c)(i) above, and (b) the Market Making Party will have the option to execute a transaction

²³ This provision applies regardless of the number and status of Market Making Parties and Rebutting Parties - prices from a designated clearing house essentially trump all other prices in the DR process.

²⁴ In the case where there are only the two Market Maker Quotes and no Reference Quotes can be obtained, this calculation yields the mathematical mid-point between the two parties; cf Method 4a-1 in the DR Protocol.

²⁵ That is, the Market Maker Quote and at least one Reference Quote.

²⁶ This is designed to ensure that an unreasonable divergence cannot exist between a two-way, firm, executable quote given as a Market Maker Quote and the financial records of the firm. Because those financial records are subject to periodic internal verification by independent controllers, oversight by management, and review by auditors and regulators this provision provides some level of assurance that the firm's collateral call genuinely reflects its view of the product's value and appropriate valuation standards. It is noted that a two-way, firm, executable price will always be given as of a certain instant in time, whereas books and records are typically based on closing prices.

²⁷ It is accepted that while a party may have the legal capacity to execute such a trade, they may not have the practical ability to do so in all cases, for example where credit appetite, available cash, bylaws prohibiting un-hedged positions, or other factors impede action.

at the stated bid or offer with the Intermediary Dealer, who in turn shall have the option to execute a transaction at the stated bid or offer with the Rebutting Party, all consistent with 6.3(x)²⁸.

Special Commentary from the Drafting Group Regarding 6.4(iv)(c)(ii)

This scenario has been examined exhaustively by representatives of the Drafting Group drawn from both dealers and buy side firms. The scenario will typically arise between a dealer and a buy side firm. However, it may also arise between dealers if one is making a market and the other is not (perhaps because it elects not to, or has exited a business line but maintains legacy positions, or the trade in question was executed by a proprietary trading desk).

The scenario presents issues that are extremely hard to resolve, and go to fundamental questions, including what constitutes a “market”. The principal issue is that where all attempts to obtain two-way, firm, executable quotes from Reference Market-makers have failed and the only such data point is the Market Maker Quote, how can one be certain that the Market Maker Quote is truly valid?

For the avoidance of doubt, the following narrow fact pattern is the one in question:

- A margin dispute that has been processed through Steps 1, 2, 3 and 4a without resolution.
- Step 4b has been attempted, in which the dealer makes a Market Maker Quote and both parties working together are unable to obtain any Reference Quotes.
- Nonetheless, the Rebutting Party feels that the Market Maker Quote may not be valid or reliable, either due to errors/omissions or absence of functional market activity that might confirm the validity of the quote.

These circumstances describe a market that is essentially inactive. If there is only one party making a two-way market and no trades are being executed, is that market actually functional and is the two-way quote provided actually valid? Some have suggested that the existence of a single two-way quote defines a market because it makes it feasible for trades to cross. Others have suggested that in the absence of any recently crossed trades, the informational value of that two-way quote may be impaired, possibly substantially.

In these circumstances, should the Market Maker Quote be definitive, should there be some additional provisions, options or protections available to the other party, or should some alternative mechanism be used for resolving the dispute?

In the text as currently written, the approach taken by the Drafting Group has been to provide for a series of options that may provide re-assurance to the Rebutting Party that the Market Maker Quote has validity. Thus we see options such as:

- Obtain a certification that the mid-point of the Market Maker Quote reflects the valuation recorded in the books and records of the other party.
- Execute at the Market Maker Quote.

²⁸ This provision allows a Rebutting Party who is willing to act like a market maker and make a two-way, firm, executable price to have their quote afforded equal weight to that of the Market Making Party. Their two-way, firm, executable quote needs to be “sleeved” via an Intermediate Dealer in order to insulate the credit risk of the parties from one another (removing credit considerations as a possible impediment to crossing a trade at the quoted levels). In this situation, in accordance with 6.3(x) all parties expressing two-way, firm, executable prices may be subject to being called upon to transact. This provision create a level playing field between a dealer who makes a market and an end-user who is willing to be equally committed by making a two-way, firm, executable price.

- Make a two-way, firm, executable price via another Reference Market-maker, thus counterbalancing the dealer's view and levelling the basis for calculation of the result.

However, although each such measure may provide some additional assurance that the Market Maker Quote is valid, it does not guarantee that as a fact. The Drafting Group has considered a range of other ideas, to provide an alternate mechanism for resolution such as the use of indicative quotes to moderate the Market Maker Quote, or a mechanical process to split (not necessarily evenly) the difference between the parties. The idea of posting disputed collateral amounts in escrow has also been considered. Suggestions for other classes of approach have also received consideration, including:

- An arbitration process, whereby a panel of qualified market participants would be convened to make a binary determination between the values of the two parties.
- A mediation process, whereby the parties would discuss their differences in the presence of an independent third party and try to reach agreement on the collateral amount to be moved.

However, so far no method is free from significant issues and has universal agreement.

As it applies to trades between dealers, there appears to be a reasonable level of comfort with section 6.4(iv)(c)(ii) as written, but there is also an acceptance that it does not legislate for every possible concern. Because buy side firms are not typically making two-way markets, there is an issue that in case of a complete absence of market quotes and an absence of recent trading activity, the mechanism as written may not provide adequate resolution.

Therefore, noting the foregoing, we specifically invite comments from interested parties on (a) whether or not these options are adequate to provide a reasonable assurance that the Market Maker Quote is valid, or (b) other alternative approaches to provide a definitive result.

(d) No Market Making Party and Two Rebutting Parties

1. Any Reference Quotes are pooled together and ordered by the following preference categories
 - 1st Preference : two-way, firm, executable
 - 2nd Preference : indicative prices, both two-way and mid-market taken together
 2. If at least one two-way, firm, executable quote is obtained, indicative quotes are discarded.
 3. The remaining bids (if any) are averaged, the remaining offers (if any) are averaged, and the mid-point between the average bid and the average offer is obtained. This is in turn averaged with remaining mid-market indicative quotes (if any), and the result is deemed to be the mid-market value for the trade(s) in question
- v) When a mid-market value of a trade is obtained, then this value shall be substituted by the Valuation Agent(s) as the value for the trade in question in the latest margin calculation between the parties. The resulting collateral requirement is binding on the parties and must be settled as soon as is practicable, in accordance with the terms of the CSA.

6.5 Intractable Dispute Disclosure

In the event that the parties have failed to achieve a resolution to their disputed margin call via any of the methods set forth in the DR Protocol, an Intractable Dispute shall be declared. Each party shall be obliged

to notify its primary regulatory supervising agency²⁹ of the details of an Intractable Dispute within 30 days of the dispute originally arising³⁰.

6.6 Longevity of results

- i) Except as otherwise provided, the results obtained through the mechanism set out above shall continue to be used for the purpose of computing margin calls between the parties until such time as the relevant markets move or additional transparency of fair value develops.
- ii) While it is intended that a result validly arrived at shall be used for future margin call calculations in order to avoid the burden and expense of the parties repeating this process unnecessarily, either party may consider in respect of any future margin call that a market movement or the development of additional transparency has occurred, and may therefore terminate the continued use of the result obtained above.
- iii) Notwithstanding the foregoing, in practice, it is expected that parties may agree to some period of time during which they will use the above result and then review the situation, repeating the dispute resolution process if then warranted.

7 Reporting

- 7.1** Statistical Reporting. Firm managements will likely require statistical reporting about disputed margin calls and their resolution. It is also anticipated that supervisors will require some level of regular statistical reporting regarding transaction differences resolved through the DR protocol. Therefore a standard set of metrics is proposed to facilitate comparison of performance, both on a disclosed basis to each firm's regulator and (potentially) on an anonymous basis for the purpose of industry benchmarking.
- 7.2** Firms should track (either themselves or via a vendor service) statistics around the Dispute Resolution process³¹.
- 7.3** Age is counted from the day T on which a margin call is disputed (the call may have been originally made on T or T-1). Each dispute event is separate for these purposes.
- 7.4** Regulatory Notification. It is also anticipated that supervisors may require notification of any transactions that reach key points in the DR protocol. Any such requirement will properly be advised by supervisors and is noted here for information. Industry practitioners would be happy to discuss with the supervisory community the nature and timing of the disclosures that might be most appropriate and practical.

8 Implementation Considerations

- 8.1** An implementation timetable will be developed and agreed with supervisors
- 8.2** It may be advantageous to roll out by industry segment, e.g. Fed 16 banks first, followed by other groups. A decision on this will be taken during the development of the implementation plan.
- 8.3** One of the major elements of implementation will be the technical drafting of the detailed DR Protocol language.

²⁹ Most entities will be subject to some form of regulatory oversight within the particular industry and jurisdiction in which they operate. If an entity is not subject to any such regulatory oversight then it must determine in its discretion what action, if any, it needs to take under this provision.

³⁰ It is assumed that following this disclosure the parties will engage in discussion with relevant regulators and either resolution action will result or it will be agreed to monitor the situation and take other risk mitigation steps as appropriate. There may be no method of satisfactorily resolving differences of valuation opinion between two firms where the trade concerned is highly customized and structured, there is no market for the product at that time, or there are no other third parties who might be qualified or willing to evaluate the value of the trade. In the future market, given all of the resolution actions set out in Steps 1 through 4b, the occurrence of Intractable Disputes is judged to be very rare.

³¹ Exact details of information to be captured and reported will be determined as part of implementation planning in respect of any industry-standard reporting required. It may include such data as the number of margin calls at different steps in the DR Protocol and statistics on the final method of disposition of disputes.

- 8.4** A further important element of implementation will be the nature of market adoption of the DR Protocol. It may be made available as an ISDA-sponsored protocol for adoption by firms during a defined adherence window; it may be provided as a standard-alone amendment for pairs of counterparties to bilaterally negotiate; it may be afforded the status of an industry best practice or guidance document. Each of these options has pros and cons and the determination of best adoption approach will be made after the consultation period as the implementation plan is devised³².
- 8.5** Finally, one question raised during the preparation of this proposal is the extent to which (if at all) the results of the dispute resolution process will be determinative of the books and records values held by the two parties. This is a technical accounting question which each firm must answer in their unique circumstances. As a general statement, it is not the intent that the result of the dispute resolution process should necessarily be definitive for books and records purposes. However, if there are limited or no other observable price inputs, the results of the dispute resolution process may assume greater importance in fair value determination. An ancillary question to be considered is the extent to which (if at all) a dispute resolution result for a particular trade with a particular counterparty should influence fair value determination for a similar trade (perhaps with some different characteristics) with an unconnected counterparty with whom there may be no extant margin dispute, and vice versa. A further related question is the extent to which (if at all) it may be prudent for a firm to maintain general or specific balance sheet reserves against the potential mismatch of levels to which collateral is posted versus levels to which the firm marks its books and records. As stated previously, these are complex, technical accounting questions on which firms should seek qualified advice as part of their implementation of the DR Protocol.

³² Although not determinative as to the eventual method of implementation, it is noted that a number of market participants have indicated informally that they consider the DR Protocol as best practice which (a) is adaptable to most but possibly not all situations and (b) is potentially able to form the basis of legal obligations between two parties in some but not necessarily all situations. Whether or not this forms the basis for documentary changes, and if not how it interfaces to existing documentation will be considered during the implementation planning phase.