



International Swaps and Derivatives Association, Inc.
One Bishops Square
London E1 6AD
United Kingdom
Telephone: 44 (20) 3088 3550
Facsimile: 44 (20) 3088 3555
email: isdaeuropa@isda.org
website: www.isda.org

June 2, 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,

The Major Dealers in the OTC derivatives market have previously set out a comprehensive set of commitments to reform market practice in the collateral management space (industry letters of October 31, 2008 and December, 31 2008). The three pillars of those commitments were:

- a) To rapidly put in place robust **Portfolio Reconciliation** practice to detect significant trade population and valuation differences that could give rise to disputed collateral calls;
- b) To set out a **Roadmap for Collateral Management** that will guide the evolution of this segment of the market over the coming years; and
- c) To follow that up with a new **Collateral Dispute Resolution** process for the industry.

We have already delivered several commitments in regard to Portfolio Reconciliation, and in the latest industry letter, published contemporaneously with this letter, we take those commitments further.

In this letter, we address the [Roadmap for Collateral Management and Collateral Dispute Resolution](#) .

Roadmap for Collateral Management

In the attached document we have set for the industry both near term and longer term goals in the field of collateral management. We cover a nominal two year time horizon, though would expect to revisit this and update it annually. The inter-disciplinary nature of this field means that some of our objectives are complex and require co-operation across trading desks, legal departments, credit risk managers and collateral practitioners not only within firms but between them too. External agencies such as industry associations, law firms, academics and regulators globally will also have a critical role to play in supporting and reinforcing the implementation of these goals, and we call for a coordinated effort to assist in accomplishing this plan. Lastly, we have been acutely aware of the limited amount of industry resources available across buy- and sell-side firms to support multiple concurrent initiatives. Therefore, the ISDA Collateral Committee has prioritized the available ideas and is committing to attack the highest priority ones first.

Collateral Dispute Resolution

The attached document outlines the proposal for a new framework to resolve disputed collateral calls. We are splitting the proposal into two phases: Phase 1 is published today and sets forth the procedural framework for identifying and resolving disputes, plus several specific resolution methods the parties may adopt; Phase 2 will be published in a month and will address the resolution methods that may be required for more complex, structured or illiquid transactions. Both phases will be subject to a public comment period before being finalized.

We note that this dispute resolution proposal is the culmination of several months of intensive work by industry specialists across dealers, buy-side firms and law firms. One of the major challenges of this topic is that the dispute resolution process employed in the market must be flexible enough to cope with the spectrum from large disputes on highly complex single trades to many individually insignificant differences on a large portfolio of trades that in aggregate lead to a material dispute. We also have to deal with valuation differences across all asset classes from vanilla rate derivatives to commodity derivatives to credit derivatives, each with their market idiosyncrasies. The mechanism must operate across small portfolios and large inter-dealer portfolios numbering tens of thousands of transactions. The proposal must legislate both for business-as-usual situations and stressed credit situations where the parties may wish to expedite the process. And finally, it is important to note that in any bilateral privately negotiated contract the parties are free to deal flexibly with disputes as they may mutually agree, and are not under a compulsion to collateralize all credit risk if they can prudentially tolerate the risk of not doing so. These considerations have underpinned the thinking of the working group which developed the proposal.

The level and breadth of industry engagement to date on these important topics has been most encouraging, and we look forward to receiving comments from banks, end-users, the regulatory community, and other interested parties.

We would be delighted to discuss any aspect of the Collateral Dispute Resolution Protocol or the Roadmap for Collateral Management in more detail, and will also continue to keep your staff updated with progress on future deliverables.

Yours sincerely,

Julian Day
Head of Trading Infrastructure
International Swaps and Derivatives Association, Inc. (ISDA)

Michael Clarke
Managing Director, UBS AG
ISDA Collateral Committee Co-Chair

Shaun Sheppard
Executive Director, Goldman Sachs
ISDA Collateral Committee Co-Chair

Arthur Magnus
Managing Director, JP Morgan Chase
Chair, Collateral Roadmap Working Group, ISDA Collateral Committee

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. The Collateral Committee has approved the release of the attached documents for comment. 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.

*Bank of America, N.A.
Barclays Capital
BNP Paribas
Citigroup
Credit Suisse
Deutsche Bank AG
Dresdner Kleinwort
Goldman, Sachs & Co.
AllianceBernstein
BlueMountain Capital Management LLC
Citadel Investment Group, L.L.C.
GLG Partners LP
Goldman Sachs Asset Management
Asset Management Group of the Securities
Industry and Financial Markets Association*

*HSBC Group
JP Morgan Chase
Merrill Lynch
Morgan Stanley
The Royal Bank of Scotland Group
Société Générale
UBS AG
Wachovia Bank N.A
Wellington Management Company, LLP
International Swaps and Derivatives Association, Inc.
ISDA Board Oversight Committee
Managed Funds Association
Pacific Investment Management Company, LLC*

The Roadmap for Collateral Management

Table of Contents

1. “Best Practices” Document for Collateral Management.....	4
2. Standardized Electronic Communication of Margin Calls and Interest Payments	4
3. Approach for Handling Independent Amount.....	5
4. Revisions to the CSA	5
5. Portfolio Reconciliation Targets	5

The essential elements of the Roadmap are:

1. “Best Practices” Document for Collateral Management

Given last year’s market events, we believe a “Best Practices” document for collateral management is needed, to be sponsored and adhered to across both buy-side and sell-side participants in the market. We will identify the best-in-class standards that are being used in the market today and work towards having firms adopt these practices over time. The document will distinguish between current best practices and aspirational best practices we would ideally adopt when the industry is ready. In drafting, we will be cognizant of other industry initiatives and adjust the content accordingly. We intend this document to contain best practices focused specifically on the collateral operations aspects covering the following areas:

- Contents, issuance timing and settlement of margin calls
- Operational procedures for dealing with maintaining data quality
- Valuation and calculation of margin exposure for both independent margin and variation margin
- Handling of special life cycle events such as credit events, settlement risk of unwinds, novations, etc.
- Portfolio Reconciliations, which will be published by December 2009 as a separate document
- Dispute Resolution based on the work to be delivered in May and June as appropriate

Commitment: The “Best Practices” document will be published by June 30, 2010.

2. Standardized Electronic Communication of Margin Calls and Interest Payments

The Collateral Management function currently exchanges margin call notices, confirmation of interest settlements and requests for collateral substitutions using undefined standards delivered via various media; predominately email. It is recognized that in order to increase automation, allow for scalability, enhance security, and provide an audit trail of message exchanges, there is a need to move towards tools which facilitate these messages to be exchanged electronically between participants in an open standard which allows for interoperability between existing platforms. To facilitate this, we commit to deliver the following:

- 1) A proposal which defines the sequence of messages to be exchanged electronically between parties for the following processes: Margin call, Interest Payment & Collateral Substitution; and

- 2) For each defined message exchange in relation to the processes described in 1) above, define the attributes of each message, including a proposal for the optimal timing and frequency of each message.

Although we commit to establishing this proposal by the dates specified, implementation dates are largely dependent on technology and vendor deliverables.

Commitment: A first draft of the proposal will be made available for comment to the ISDA Collateral Committee by July 31, 2009, with a final version to be published by October 31, 2009.

3. Approach for Handling Independent Amount

The topic focuses on providing a structure for holding independent amount / initial margin as collateral that is 'bankruptcy remote' from the secured party. The Hedge Fund community (as the Initial Margin pledgor) and increasingly other end-users see this as a key consideration in managing their risk with dealers, especially after some loss experiences related to dealer insolvencies in 2008. Dealers maintain a desire to continue to have unimpeded access to Initial Margin in the event of counterparty default, and also increasing risks to the custodians both from a credit and an operational risk perspective. It is apparent that in today's environment this is an important issue which needs proper attention.

The topic is concerned with uni-lateral pledging of initial margin and is distinct from the discussion focused on segregation of client collateral taking place in other OMG streams related to Central Counterparties (CCPs).

Commitment:

- 1) Detailed paper on both the buy- and sell-side views of the issue, distributed to ISDA, MFA and SIFMA by June 30, 2009.
- 2) The ISDA Collateral Committee will work with the broader ISDA, MFA, and SIFMA communities to produce a set of options for industry consideration that will address the above concerns by September 30, 2009. The options will include pros, cons, and pre-conditions for each stated option.

4. Revisions to the CSA

After completion of the Best Practices document and other commitments made in this letter, we will have a clear understanding of whether changes are needed or desired in the CSA. If required, we will work with ISDA Legal and Documentation in 2010 to thoroughly review the CSA and identify other changes required to improve and strengthen collateral risk management and collateral operations in addition to those required to help us achieve the deliverables committed to in this Roadmap.

Commitment: If any are identified, a list of changes to the CSA will be collated by April 2010 and we will bring any recommendations to ISDA Legal and Documentation groups.

5. Portfolio Reconciliation Targets

In addition to the commitments already made in the December letter for the Major Dealers (Best Practices, agreed and implemented risk-based threshold, daily portfolio upload, weekly portfolio reconciliation for portfolios >500 trades) and the new commitment to execute daily¹ collateralized portfolio

¹ Daily is defined as at least 16 reconciliations per month to be consistent with existing portfolio reconciliation metrics provided to the supervisors.

reconciliations² for collateralized portfolios in excess of 500 trades between OMG dealers, we are also working with the buy-side/non dealer firms on developing a plan for further portfolio reconciliation improvements and goals. To achieve this we will publish a feasibility study by September on market-wide portfolio reconciliation that will set out how the discipline of regular portfolio reconciliations can be practically extended beyond the current OMG dealers to include smaller banks, buy-side participants and derivative end-users. The study will look to capture market requirements, challenges, potential solutions and dependencies. The study will be undertaken by representatives of dealer and buy-side firms under the auspices of the ISDA Collateral Committee.

Whilst portfolio reconciliation is clearly a subject of interest to buy-side and non-dealer firms alike, take-up throughout the industry is still generally at an emerging stage. A number of large buy-side firms have experience in reconciling portfolios using in-house tools, and market vendors provide services in this area. The industry engagement process has been encouraging and productive resulting in a general agreement and willingness to work together to onboard further counterparties.

To achieve this goal, the OTC community appreciates that a number of dependencies exist and, from a practical perspective, will need to be overcome:

- **Transparency:** All parties will need to utilize a reconciliation model which enables both sides to view the results and work on any breaks
- **Technology and Inter-operability:** A practical solution is required for those firms using in-house reconciliation tools and those requiring to use different market services. At a minimum reconciliation results will need to be transparent and accessible by both parties, but service providers must offer functionality which enables reconciliations to take place between users of different services to an agreed quality standard.
- **Data Quality:** Adoption of a minimum market standard for data presentation and field formats applicable to all users when presenting portfolios for reconciliation
- **Bi-lateral commitment:** Both parties need to agree to provide data and to commit to reconcile trade portfolios to common market standards (Best Practices)

The industry engagement process is addressing a number of these issues through Portfolio Reconciliation Best Practices due to be published by the end of this year. The Data Quality and Minimum Market Standards is a major piece of work covering all OTC product classes to provide guidance for new entrants and ensure consistent standards from more experienced firms. When this work is finished by the end of 2009, the Major Dealers working alongside non-dealers and buy-side firms will be better positioned to recommend a Portfolio Reconciliation implementation roadmap for 2010 and will have gauged the industry's interest and appetite for implementing new measures. To this end, buy-side and sell-side firms will work collaboratively and with vendors to identify technology solutions to support a wider rollout of portfolio reconciliation during 2010.

Commitment: Carry out and publish a feasibility study to identify infrastructure and other dependencies for wider portfolio reconciliation rollout across OTC participants by October 31, 2009.

The new Roadmap commitments mentioned above will be delivered in addition to the targets stated in our previous industry letters to the supervisory community. The table below recaps those for completeness and also adds the new commitments to provide a comprehensive overview.

² Collateralized Portfolio Reconciliation is defined as 1) Uploading the collateralized portfolio 2) Reconciling/Matching the collateralized portfolio 3) Releasing/publishing the results to both parties involved. Parties are expected to follow their own internal procedures for the investigation of portfolio reconciliation differences, consistent with their risk assessment of each counterparty situation and any investigation already on-going in respect of differences previously identified.

Table 1 - The Roadmap for Collateral Management

New Roadmap Commitments are highlighted in Bold

<i>Date</i>	<i>Commitment</i>
March 31, 2009	1. Replace affixed USD 20mm tolerance with a risk-based reporting threshold for portfolio reconciliations. The new tolerance reduces the absolute dollar level for reporting of material valuation differences from USD 20mm per trade to USD 10mm per trade plus a deviation threshold by product.
May 31, 2009	2. Implement the new risk-based threshold for reporting portfolio reconciliation valuation differences on May 31, 2009. The first report utilizing the new threshold will be available early July for the June report. The threshold will be reviewed (at least) annually and revised as necessary.
May 31, 2009	3. Issue the Phase 1 draft Dispute Resolution proposal by the end of May, to be followed by a comment period of 3 weeks.
June 30, 2009	4. Reduce required portfolio size for weekly collateralized portfolio reconciliation from 5,000 trades to 500 trades amongst the OMG Dealers (See also Commitment 6 below)
June 30, 2009	5. The OMG Dealers will upload collateralized portfolios to their respective matching services on a daily basis (See also Commitment 6 below)
June 30, 2009	6. Execute daily collateralized portfolio reconciliations for collateralized portfolios in excess of 500 trades between OMG dealers. (This new Commitment replaces Commitments 4 and 5 above, which were less stringent)
June 30, 2009	7. Publish a detailed paper on both the buy- and sell-side views of the Segregated Initial Margin issue to the ISDA Collateral Committee, MFA and SIFMA
June 30, 2009	8. Issue the Phase 2 draft Dispute Resolution proposal by the end of June, to be followed by a comment period <i>to be determined</i> over the summer
September 30, 2009	9. The ISDA Collateral Committee will work with the broader ISDA, MFA, and SIFMA communities to produce a set of options for industry consideration that will address the Segregated Initial Margin issue by September 30, 2009. The options will include pros, cons, and pre-conditions for each stated option.
October 31, 2009	10. Publish a feasibility study to identify infrastructure and other dependencies for wider portfolio reconciliation rollout across OTC participants
October 31, 2009	11. Publish for public comment a first draft of the proposal for a defined sequence of messages to be exchanged electronically for Margin call, Interest Payment and Collateral Substitution by July 31 2009, with a final version to be published by October 2009.
December 31, 2009	12. Publishing key operational standards in Portfolio Reconciliation by December 2009 which will be included in the final Best Practices document mentioned
April 30, 2010	13. If any are identified, a list of changes to the CSA will be collated and any recommendations will be brought to ISDA Legal and Documentation groups
June 30, 2010	14. Publish a "Best Practices" document for Collateral management

We strongly believe there are key opportunities to make significant improvements to review collateral operations and risk management activities across the market. However, given current market conditions, we need to maintain focus on the broader initiatives to improve market infrastructure and standards of practice holistically. We also need to work within the resource levels likely available to market participants. In addition to the topics covered above, there are larger and more aspirational changes specific to collateral management that we as an industry have discussed. However, at this time, we feel the right commitments to make are those that we can accomplish within the next 1-2 years. Even in context of the resource constraints experienced across the industry, we feel the foregoing commitments and targets are achievable.

There were additional items considered and discussed but due to the level of market maturity and resource contentions the industry has decided to forego actions for those topics at this point. These include the following suggestions previously mentioned in the October 2008 letter:

- Improved consistency of approach and risk profile across different types of collateralization (e.g. OTC derivatives, repo, prime brokerage, stock borrow/loan) that may lead to greater market efficiency and more effective risk reduction.
- Ideas relating to central intermediation and optimization of margin calls between counterparties, making the margin process more efficient without necessarily affecting the fundamental bilateral nature of the credit relationship between the parties.

The other items on the list have been subsumed into work driven out of other industry initiatives. These topics are:

- Evolution of collateral management as the use of central clearing arrangements for OTC derivatives expands in the future.
- Potential for use of independent valuations for certain trade types in order to establish a common basis for margin calculations or dispute resolution that could remove noise in the collateralization process, provided issues relating to fair value accounting, risk management and P&L recognition can be addressed. This topic is being considered in the context of the Central Clearing Counterparties and the new Dispute Resolution proposal.

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

Table of Contents

1 Introduction9

2 General Terms and Conditions.....10

3 Structure of the DR Protocol.....11

4 Detail of Steps 1, 2, and 3.....13

5 Detail of Step 4a - Mutual Informal Dispute Resolution15

6 Regulatory Reporting and Notification.....16

7 Implementation Considerations17

This document is an 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. This document is also available as a Powerpoint presentation in order to assist firms in the process of internal syndication and review. A companion document, the Commentary to the 2009 ISDA Protocol for Resolution of Disputed Collateral Calls (the "Commentary"), is being published simultaneously. It is recommended that the DR Protocol and the Commentary be read together.

Copyright © 2009 by the International Swaps and Derivatives Association, Inc.

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 practice in the near term coupled with continued development of certain more complex methods of dispute resolution. In summary:
 - i) Phase 1 (this document, published May 31, 2009 for comment) describes the over-arching framework for resolution of disputed margin calls

- ii) Phase 2 (to be published June 30, 2009 for comment) will provide additional methods for dealing with disputes involving complex, structured or illiquid transactions, which will inter-connect into the Phase 1 framework laid out here.
- 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 Phase 1 of the DR Protocol is open now and closes on June 21, 2009. Comments should be directed to Julian Day and Nichole Framularo at ISDA (jday@isda.org, nframularo@isda.org)
- 1.7 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 Timing. The DR Protocol sets forth specified Standard Timings for each step. In setting these Standard Timings, it is necessary to balance the operational practicality of the time required to execute each step of the process in the ordinary course of business versus the desire from a risk management perspective to make all timings as short as possible. It 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):
- 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
 - Situations where especially complex transactions are being progressed through the DR Protocol but require additional time for investigation
 - Credit stress situations in which an expedited approach is desirable

Accordingly, the following timing adjustments³ 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 4 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 days⁴ for the overall process.

³ The rationale behind the timings in the DR Protocol is the following. The Standard Timing is selected to be operationally feasible, if demanding, but not so long as to introduce excessive additional risk intervals that would adversely impact risk computations. 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 a 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. 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.

⁴ 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.

- 2.4** 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.
- 2.5** 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 or modified times, if applicable), the other party can unilaterally decide to accelerate to the next step.
- 2.6** 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** Timings are expressed as a number of elapsed business days after day T.
- 3.4** 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))
- 3.5** Step 2 : Portfolio Reconciliation
- i) Step 2 starts on T and ends on T+1
 - ii) The parties exchange portfolio details and perform a portfolio reconciliation⁷
 - iii) Trades with difference greater than the Tolerance level (see 3.6) and all unmatched trades must be ring-fenced as Transactions Under Investigation and proceed to Step 3.
 - iv) In addition, trades with difference less than the Tolerance level can be deemed Transactions Under Investigation by either party and proceed to Step 3.
- 3.6** 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 at \$20mm per trade, but later in 2009 this is due to decrease to \$10mm plus a risk-based deviation for different product types. 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.

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.

3.7 Step 3 : Consultation

- i) Step 3 starts on T+2 and ends on T+4
- ii) For Transactions Under Investigation, both parties will have their internal trading desk or financial controllers confirm their marks.
- iii) For any transactions internally re-affirmed above, desk-to-desk conversation between the counterparties will take place as needed to resolve valuation differences
- iv) 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.
- v) 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 execution⁸
- vi) Any Transactions Under Investigation, excluding unmatched trades, not resolved by T+4 become Trades Under Dispute Resolution and proceed to Step 4

3.8 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 3.7 (v)) 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.

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

- i) Step 4 starts on T+5 and ends on T+7
- ii) The parties may mutually elect one of the following methods to resolve:
 - 4a-1 Temporary Collateral Adjustment
 - 4a-2 Use of Common Reference Pricing
 - 4a-3 Mutually Agreed Exit of Position
 - 4a-4 Other Resolution Method
- iii) 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.

3.10 Step 4 : Dispute Resolution – Part 4b Third Party Formal Dispute Resolution

- i) The methods and details available in Step 4b will be part of DR Protocol Phase 2 due to be delivered in June 2009.
- ii) This section is therefore intentionally left blank.
- iii) There is an automatic extension of [xx]⁹ days once Step 4b is invoked.

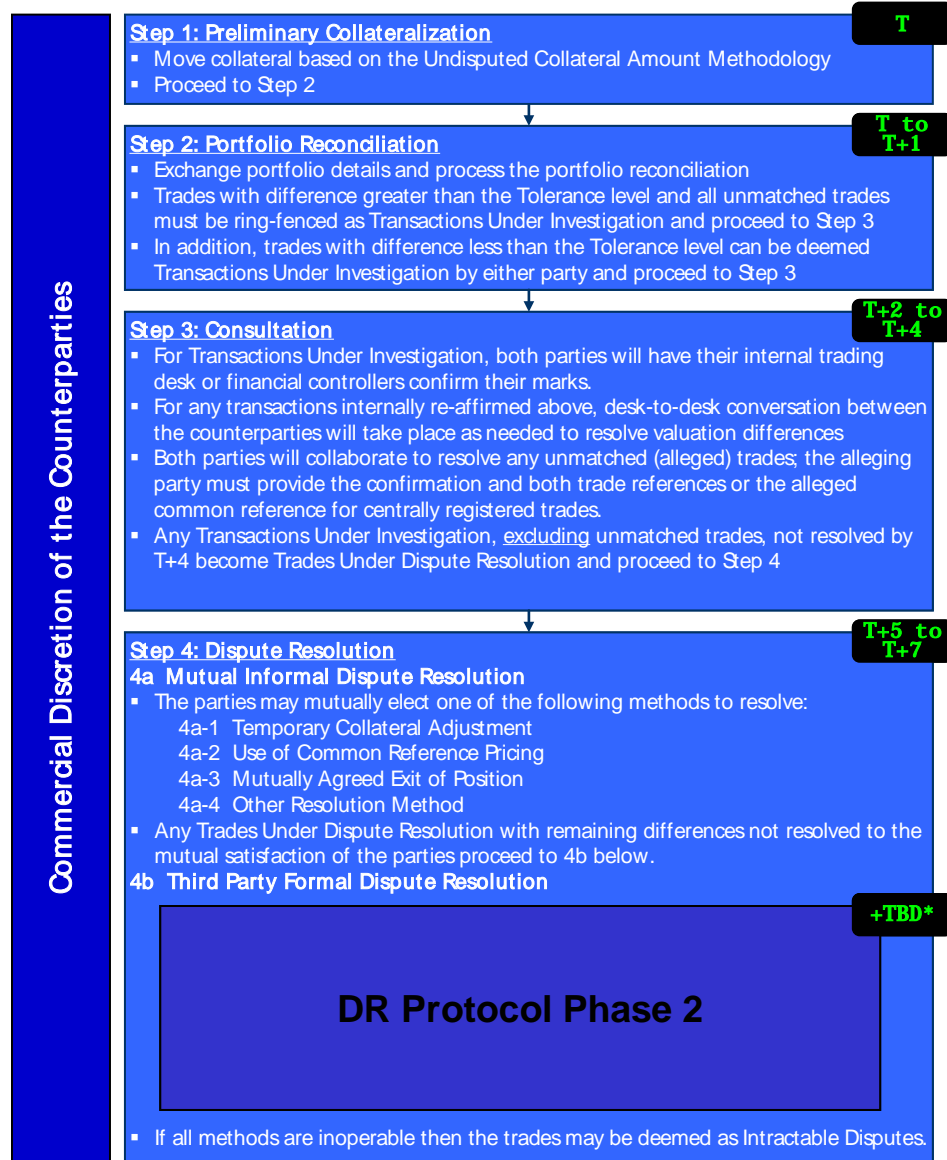
3.11 If all methods in Step 4 (both 4a and 4b) are inoperable then the trades may be deemed as Intractable Disputes.

3.12 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.

⁸ 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.

⁹ To be determined as part of the DR Protocol Phase 2.

3.13 The diagram below illustrates the DR Protocol in summary:



* Automatic extension of [xx] days once Step 4b is invoked. Length of time to be defined in Phase 2.

4 Detail of Steps 1, 2, and 3

4.1 Step 1 : Preliminary Collateralization

- 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.
- 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.
- 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.
- 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
X calls, Y 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 by the end of T+1.
- 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 head¹⁰.
- 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:
 - (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.

¹⁰ 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.

- v) Each party must identify the internal owner of each Transaction Under Investigation and facilitate a timely discussion with the relevant counterpart 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 alleges must be resolved by T+4
 - (b) All items entering Step 3 that remain unresolved by T+4 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. It is intended that no P&L consequences should arise for either party as a result of this method being employed, and that results achieved via this method shall not automatically be deemed valid inputs to fair market value determination.
- 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 pricing¹¹.

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

- i) Parties may elect to use this method if both agree to do so

¹¹Arguably, 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.

- 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 ongoing 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
- iv) It is strongly recommended that to the extent that any of these or other resolution methods lead to a partial solution with some measure of risk left uncovered by collateral, each party should consider appropriate risk hedges, reserves or other measures to economically protect against that open risk. It is noted that there will be a regulatory capital cost in relation to any unsecured risk under the Basel Capital Accord.

6 Reporting

- 6.1 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.
- 6.2 Firms should track (either themselves or via a vendor service) statistics around the Dispute Resolution process¹².
- 6.3 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.
- 6.4 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.

¹² 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.

7 Implementation Considerations

- 7.1** The DR Protocol Phase 1 will be subject of a comment period from publication on May 31, 2009 until June 19, 2009.
- 7.2** In parallel, the proposal for Phase 2 will be developed. This is due for publication on June 30, 2009 and will again be followed by a comment period.
- 7.3** Subsequent to the Phase 1 comment period closing, revisions will be made as appropriate and a final version published.
- 7.4** An implementation timetable will be developed and agreed with supervisors
- 7.5** As the work on Phase 2 is concluded and comments received, that too will be factored into the implementation timetable.
- 7.6** It may be advantageous to roll out by industry segment, eg Fed 16 banks first, followed by other groups. A decision on this will be taken during the development of the implementation plan.
- 7.7** One of the major elements of implementation will be the technical drafting of the detailed DR Protocol language.
- 7.8** 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 devised.