

## ISDA Collateral Committee

# Commentary to the Outline of the 2009 ISDA Protocol for Resolution of Disputed Collateral Calls

**DRAFT**

This document is intended to be read in conjunction with the  
**Outline of the 2009 ISDA Protocol for Resolution of Disputed Collateral Calls**  
(the “DR Protocol”), Version F3 – June 2, 2009

Any references to Phase 2 details in this document are not agreed, do not form part of the Phase 1 Proposal and are subject to extensive revision or removal in the eventual Phase 2 Proposal

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***Notes on the Commentary***

The Commentary provides ancillary information to be read in conjunction with the DR Protocol Outline document. In some cases this contains additional detail of specifics of the DR Protocol, and in other cases is more educational or general discussion material. The structure of the Commentary follows the structure of the Outline, and each entry is flagged to indicate the particular paragraph in the Outline to which it relates.

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## **1 Introduction**

### **1.1 Executive Summary**

[See Outline Section](#)

**1**

- a. During the 2007/2008 credit market crisis, there was a material increase in the number of collateral calls in the OTC derivative market that were disputed. Some disputes proved large in amount and intractable over long periods of time.
- b. The two most common fundamental causes of disputed collateral calls are (a) mismatched trade populations and (b) valuation differences between the two counterparties.
- c. The industry responded in four significant ways:
  1. By tightening standards and performance relating to trade confirmations, to avoid some of the underlying causes of disputed collateral calls
  2. By implementing central counterparty arrangements for certain types of derivatives which establish a definitive value that must be collateralized, thus avoiding some other underlying causes of disputed collateral calls.
  3. By developing and adopting new capabilities for portfolio reconciliation, to allow early detection and reliable characterization of the causes of disputed collateral calls
  4. By developing new dispute resolution procedures to replace those currently in use across the industry
- d. This document outlines the proposed new dispute resolution procedures which essentially provide for:
  1. An agreed industry-standard approach to dealing with disputed collateral calls
  2. A clear structure for the process, including defined timelines
  3. A Preliminary Collateralization phase to ensure quick settlement of as much collateral as can be agreed between the parties, providing a measure of credit protection while the parties proceed through the resolution process
  4. An obligation to investigate portfolio differences, including via portfolio reconciliation
  5. An obligation and specific structure to permit Consultation between the parties to resolve apparent differences
  6. A range of alternative methods the parties may adopt for Dispute Resolution of trade differences not resolved through consultation
- e. This proposal is also consistent with recommendations V-10, V-11 and V-12 of the CRMPG III report, "Containing Systemic Risk : The Road to Reform" (Counterparty Risk Management Policy Group, August 6th 2008)

### **1.2 Problem Statement**

- a. Disputed margin calls have increased significantly since late 2007, and especially during 2008 have been the driver of large (sometimes > \$1 billion) un-collateralized exposures between professional firms.
- b. The current ISDA Credit Support Annex language does not adequately address the complexities of disputed margin calls or their drivers. The method provided for dispute resolution is not practical in the case of certain transaction types, tends to leave one party partially un-secured for a period of resolution time that may run to weeks or months very easily, and in certain circumstances produces a "deadlock" where neither party can impress its claim for collateral on the other.

c. Figure: ISDA CSA Paragraph 4 (English Law CSA)

**Paragraph 4. Dispute Resolution**

**a) Disputed Calculations or Valuations.** If a party (a "Disputing Party") reasonably disputes (i) the Valuation Agent's calculation of a Delivery Amount or a Return Amount or (ii) the Value of any transfer of Eligible Credit Support or Equivalent Credit Support, then:

- 1) the Disputing Party will notify the other party and the Valuation Agent (if the Valuation Agent is not the other party) not later than the close of business on the **Local Business Day following**, in the case of (i) above, the date that the demand is received under Paragraph 2 or, in the case of (ii) above, the date of transfer;
- 2) in the case of (i) above, the appropriate party will **transfer the undisputed amount** to the other party not later than the close of business on the Settlement Day following the date that the demand is received under Paragraph 2;
- 3) the parties **will consult with each other in an attempt to resolve the dispute**, and
- 4) if they fail to resolve the dispute by the Resolution Time, then:
  - i. in the case of a dispute involving a Delivery Amount or Return Amount, unless otherwise specified in Paragraph 11(c), the Valuation Agent will recalculate the Exposure and the Value as of the Recalculation Date by:
    - A. utilising any calculations of that part of the Exposure attributable to the Transactions that the parties have agreed are not in dispute;
    - B. **calculating that part of the Exposure attributable to the Transactions in dispute by seeking four actual quotations at mid-market from Reference Market-makers for purposes of calculating Market Quotation, and taking the arithmetic average of those obtained; provided that if four quotations are not available for a particular Transaction, then fewer than four quotations may be used for that Transaction, and if no quotations are available for a particular Transaction, then the Valuation Agent's original calculations will be used for the Transaction; and**
    - C. utilising the procedures specified in Paragraph 11(e)(ii) for calculating the Value, if disputed, of the outstanding Credit Support Balance;
  - ii. in the case of a dispute involving the Value of any transfer of Eligible Credit Support or Equivalent Credit Support, the Valuation Agent will recalculate the Value as of the date of transfer pursuant to Paragraph 11(e)(ii).

Following a recalculation pursuant to this Paragraph, the Valuation Agent will notify each party (or the other party, if the Valuation Agent is a party) as soon as possible but in any event not later than the Notification Time on the Local Business Day following the Resolution Time. The appropriate party will, upon demand following such notice given by the Valuation Agent or a resolution pursuant to 3) above and subject to Paragraph 11(e), apply the procedures set out in this Paragraph 4 to the relevant transactions. The application of these procedures will not constitute an Event of Default for as long as the procedures set out in this Paragraph 4 are being carried out. For the avoidance of doubt, upon completion of those procedures, Section 5(a)(i) of this Agreement will apply to any failure by a party to make a transfer required under the final sentence of Paragraph 4(a) on the relevant due date.

**Callout Boxes:**

- Top Left:** Allows too long an elapse of time before a dispute becomes apparent – increased risk
- Top Right:** Often parties decline to transfer undisputed amount or there is no undisputed amount – e.g. both parties calling each other
- Middle Left:** Undefined what "consult with each other" means
- Middle Right:** Dealer poll is often impossible to perform as the number of dealers willing to participate is zero – especially for complex structured products where market expertise to price may be thin. Also, no compulsion or compensation for dealers to participate. If zero quotes, the Valuation Agent opinion dominates
- Bottom Right:** Entire process needs to be repeated for every disputed margin call (potentially). Dispute resolution outcomes do not have any longevity

d. In late summer 2008, the ISDA Board committed to ask some of its members to begin the field of collateral dispute resolution and to identify/discuss new approaches to resolve disputes.

e. In various subsequent industry letters to the Fed, the industry and ISDA committed to deliver recommendations around standards, practices and potential improvements in collateral dispute resolution by the end of April 2009<sup>1</sup>.

f. The proposed 2009 ISDA Protocol for Resolution of Disputed Collateral Calls (the "DR Protocol") addresses the April 2009 commitment.

## 2 General Terms and Conditions

### 2.1 Key Concepts

[See Outline Section](#)

#### 2

a. The General Terms and Conditions section outlines several key and over-arching provisions that lay the foundation for the DR Protocol. Chief among these are:

1. Freedom of the parties to contract as they wish, subject to applicable law
2. No compulsion to collateralize credit risk wholly or partially
3. Timings as indicated are defaults, but may be both accelerated and extended as warranted in the specific circumstances of each dispute.

b. In addition, it is worth noting that it is not the intent that the collateral dispute resolution process shall be, or shall be construed as, a means of discovery or development of definitive pricing or valuation for any instrument, security, position or asset. The customary market mechanism for such determinations remains the ability to enter into bilateral, privately-negotiated or exchange-intermediated transactions to buy or sell identical or similar instruments. For the avoidance of doubt, the results of the collateral dispute resolution mechanism shall not be considered to be fair market value, a trading level, an indicative price or price talk - they simply define an amount of collateral that the parties agree to move between them.

<sup>1</sup> The revised target for a Dispute Resolution Proposal is June 2, 2009 for Phase 1 and June 30, 2009 for Phase 2.

- c. It should be noted that it is normal under collateral agreements that collateral may not exactly equal the market value of underlying derivative transactions - for example, the existence of thresholds, independent amounts and other similar negotiated features of collateral agreements may move the collateral requirement substantially away from the exposure that exists at any point in time.

## **2.2 Discretion of the Parties**

- a. In the privately-negotiated market there is no compulsion for any two parties to agree upon the value of an asset at any particular point in time. This is an essential element of such markets and fundamental to their operation.
- b. It therefore follows that it may be impossible for the parties to agree upon the value of an asset for the purpose of collateralization, and this is normal.
- c. Even at the point of trade execution, there may not be agreement as to value. For example, one party may consider the other to undervalue an asset, thus making it an attractive purchase to be long that asset. Conversely, one party may consider the other to overvalue that asset, in which case they will presumably not become long that asset from that source.
- d. It is also the case that in a privately-negotiated market the parties are free to contract as they desire (not withstanding illegality) and to amend that contract as may be mutually agreed.
- e. The dispute resolution process set out herein is intended to bind the parties that agree thereto. However, the parties may agree to different procedures or resolution outcomes than those provided for in this process, if they concur that their interests would be better served by an amendment.
- f. This implies the following:
  - 1. Parties may mutually agree to fast track through the process if there is sufficient information to move to the next stage or to omit a stage
  - 2. Parties may find alternatives to resolving a dispute not set out in this process
- g. However, the process defines an agreed set of steps and obligations between the parties that absent mutual consent to do something different are intended to bind the parties and to provide a definitive method of approaching disputed margin calls.

## **3 Structure of the DR Protocol**

### **3.1 Summary of Proposed Changes** **Section 3**

[See Outline](#)

- a. Phase 1 of the current revised dispute resolution proposal envisages a more structured dispute resolution method consisting of 4 steps and provides a wider range of options for dispute resolution.
- b. *Figure: Highlights of Changes under the Proposed DR Protocol*

Issues with Current Dispute Resolution Process	Changes under the DR Protocol
<ul style="list-style-type: none"> <li>▪ No obligation to exchange portfolio information</li> <li>▪ No obligation to reconcile portfolios</li> <li>▪ No obligation to investigate differences</li> </ul>	<p><b>NEW</b></p> <ul style="list-style-type: none"> <li>▪ Obligation to exchange portfolio information within 1 day</li> <li>▪ Formal designation of "Transactions Under Investigation" with obligation to investigate</li> </ul>
<ul style="list-style-type: none"> <li>▪ Undefined requirement for consultation</li> <li>▪ No time limits on resolution process</li> <li>▪ Disputed margin calls often ignored or "waived"</li> </ul>	<p><b>IMPROVED</b></p> <ul style="list-style-type: none"> <li>▪ Explicit requirement for desk-to-desk interaction between firms as part of resolution process</li> <li>▪ 5 day time limit to resolve informally through Consultation step in process</li> </ul>
<ul style="list-style-type: none"> <li>▪ Only method for resolution is Dealer Poll</li> <li>▪ Dealer Poll as constructed under existing documentation proven to be impractical</li> <li>▪ No incentive for dealers to participate</li> <li>▪ See as uncertain process with unpredictable outcomes</li> <li>▪ No concept of longevity of results - potentially requiring daily repetition of the Dealer Poll or some other agreement</li> <li>▪ No approach to intractable differences not capable of resolution</li> </ul>	<p><b>ADDITIONAL</b></p> <ul style="list-style-type: none"> <li>▪ Encourages parties to attempt initial resolution through informal methods</li> <li>▪ Four different methods provided for Informal Dispute Resolution, permitting the parties to select the optimal method in the circumstances</li> </ul>
	<p><b>ISSUES NOT SOLVED BY DR PROTOCOL</b></p> <ul style="list-style-type: none"> <li>▪ No method of handling deadlocked margin call situations (call and counter-call)</li> <li>▪ Fundamental valuation philosophy differences</li> <li>▪ Lack of single common value for OTC derivatives</li> <li>▪ Disputes close to default</li> </ul>

## 4 Detail of Steps 1, 2 and 3

### 4.1 Step 1 - Preliminary Collateralization

[See Outline Section](#)

4

- a. Where one party disagrees with the margin call made by the other party, it is desirable that some preliminary movement of collateral takes place pending investigation and resolution of the difference - Preliminary Collateralization.
- b. There are four potential methods that could be used to determine Preliminary Collateralization:
  1. No collateral moves
  2. An Undisputed Collateral Amount is established and one party moves collateral to the other party up to this level
  3. A Midpoint Collateral Amount is established and party moves collateral to the other party up to this level
  4. Collateral is moved to satisfy the full amount of the margin call
- c. Options 1 and 4 would be unacceptable to one or both parties.
- d. Option 2 has the major drawback that if both parties are calling margin from each other (call and counter-call) then there can be no Undisputed Amount and thus no Preliminary Collateralization occurs
- e. Option 3 has the major drawback that if both parties are calling margin from each other (call and counter-call) in differing amounts, one party will end up delivering some amount of collateral when they feel they should be receiving collateral; the other party would receive collateral, but less than they were claiming. From the perspective of the first party, they will consider the collateral agreement to have increased their risk - they are delivering out when they feel they should be receiving, and would have been better off if no collateral moved at all.
- f. From a "satisfaction" perspective
  1. Option 2 has asymmetric satisfaction characteristics - one party is satisfied because they have delivered only the amount of collateral that they do not dispute; but the other party is dissatisfied because they have received only part of the collateral they consider to be due.
  2. Option 3 has symmetric satisfaction characteristics - neither party is full satisfied because one has delivered more that they believe is necessary and the other has received less than they consider to be due.

3. Arguably, Option 3 is an improvement over Option 2 because both parties are equally dissatisfied and therefore have equal incentive (absent other factors) to resolve the dispute in a thorough and timely manner. By contrast, in Option 2 the party which delivered only the Undisputed Amount has no incentive to resolve the dispute (absent other factors)

g. The Undisputed Collateral Amount is calculated as follows where:

1. M = Undisputed Collateral Amount
2. X = Party A margin call, and |X| is the absolute value of Party A margin call
3. Y = Party B margin call
4. Formula for calculating M = Min ( |X| , |Y| )

5. *Figure: Worked Examples for Calculating Undisputed Collateral Amount*

	Party A	Party B	Undisputed Collateral Amount	Resulting Collateral Movement
	X Call	Y Call	M = 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

h. The Mid Point Collateral Amount is calculated as follows where:

1. M = Mid Point Collateral Amount
2. X = Party A margin call
3. Y = Party B margin call
4. Formula for calculating M = (X-Y) / 2
5. *Figure: Worked Examples for Mid Point Collateral Amount*

	Party A	Party B	Mid Point Collateral Amount	Resulting Collateral Movement
	X Call	Y Call	$\frac{X-Y}{2}$	
Both parties counter-call - Find the mid point	10	20	-5	Party A pays Party B: 5
Both parties counter-call same amount	20	20	0	No Collateral Movement
B calls, A partially agrees - Find the mid point	-10	20	-15	Party A pays Party B: 15
A calls, B agrees to pay 10 as less than expected call	10	-20	15	Party B pays Party A: 10
In practice neither calls	-10	-20	5	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

- Exchange of portfolio details is mandated for both parties, and in general it is recommended that the parties use an industrial strength trade matching / reconciliation tool, of which several exist in the market.
- However, especially for small portfolios, the parties may use simpler methods of portfolio matching, including but not limited to use of spreadsheets, manual tickback and visual inspection; these would only likely be used for the smallest of portfolios.
- If the dispute encompasses the existence, type, quantity, balance or value of collateral assets, then such information is included within the portfolio details that the parties must exchange.
- Note that various industry commitments exist or are planned to reconcile trade portfolio details on a regular basis, and standard data formats are being developed to make this process more efficient. The DR proposal is intended to be consistent with, and to leverage from, these initiatives.

## 4.3 Step 3 – Consultation

- Although the final language may place on the parties an affirmative obligation to consult with each other, it might not necessarily stipulate in detail what that entails.

# 5 Detail of Step 4a – Mutual Informal Dispute Resolution

## 5.1 Summary Step 4a Methods – Informal Dispute Resolution

[See Outline Section](#)

5

- Four Informal Dispute Resolution methods which do not involve third parties are encouraged before disputing parties should consider a Formal Dispute Resolution
- Phase 1 contains only these methods, in Step 4a.
- Figure: Summary of Step 4a Methods

Approach	Source of Opinion	Anonymity	Dispute Resolution Method	Consent Required	Adjustment applies to...	Accounting (P&L) impact	Typical Resolution Timeframe	Outcome	Determination on Longevity of Results	Scope of Effect of Results* *	Cost
<b>Informal Dispute Resolution</b>											
Collateral Adjustment	Disputing Parties	Named	4-81 Temporary Collateral Adjustment	Yes	Collateral Requirement	Unlikely	Instant	Typically midway between margin calls of A and B, but may be asymmetrical	Disputing Parties [min 1 day, max 3 months]	Between Disputing Parties	None
Reference Pricing	Reference Pricing	Named	4-82 Use of Common Reference Pricing	Yes	Trade Valuation	Unlikely	24 - 48 hours	Value is Reference Source	Disputing Parties [min 1 day, max 3 months]	Between Disputing Parties	None
Trade Exiting	N/A	Named	4-83 Mutually Agreed Exit of Position	Yes	Trade Valuation	Potentially	Instant	Value is 0 upon settlement	Permanent	Between Disputing Parties	None
Other	Various	Either	4-84 Other Resolution Method	Yes	Various	Various	Various	Various	Various	Between Disputing Parties	Various

\* parties who may have a dispute related to similar or even identical trades. To be specific, the results from dispute resolution between A and B may not be applied to a dispute between A and some other party X, nor B and some other party Y, nor a dispute between X and Y, nor any dispute involving any other parties except for A and B. This is for two reasons : firstly, because transactions between A and B may be subtly but importantly different than those involving other parties (even so-called "back-to-back" transactions may not be perfectly symmetrical in all respects - for example, the cost of credit will differ between different pairs of counterparties most likely); secondly, because each dispute between a pair of counterparties is a separate and distinct event and needs to be resolved as

such, therefore it would not be appropriate for a dispute resolution result between A and B to automatically propagate or multiply across other counterparty relationships.

## **5.2 Other Uses of Common Reference Source Pricing (method 4-a2)**

- a. Use of a common reference source pricing can be applied in the event of a dispute. It has also been noted that this method could be applied in the ordinary (non-dispute) course of business as a way to avoid disputed collateral calls arising in the first place.
- b. In that more general case, some of the potential drawbacks of this approach include:
  1. Only partial product coverage exists from such sources and this is unlikely to change dramatically in the near term
  2. Firms may be uncomfortable mitigating their risk at a level other than their actual risk calculations indicate
  3. There will be a regulatory capital penalty for doing so under the Basel Capital Accord, if it results in some element of risk being unsecured.
  4. Firms will need to track multiple values per position (their own books and records value, plus potentially several prices provided by clearing houses). They will require logic to determine which source to use and computation to convert prices into MTM values
  5. Firms with policies that require them to use their books and records values for the purpose of margin calls would need to revise those policies
  6. Margin calls based on Common Reference Source pricing would be inconsistent with Client Valuation statements covering the same instruments.
- c. 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.
- d. Further discussion is proposed to understand the pros and cons of (and industry interest in) this approach for general use. For specific use in a dispute resolution context, however, it is believed to be a useful method.

## **5.3 Longevity of Dispute Resolution Results**

- a. The results from the DR process must have a finite longevity during which they will be used by the counterparties for the sole purpose of agreeing margin calls.
- b. In order to preserve the interests of both parties and also to balance cost and workload considerations, no DR result shall be valid for longer than 3 months. After that period of time, if a dispute still exists then the DR process must be performed again.
- c. The only exception is for methods involving an Expert, if the Expert issues a periodically revised opinion. This must happen no less frequently than once every 3 months. If such revised opinions are issued by the Expert, then the new result may be rolled into the next time period without a need to re-perform the entire DR process from the beginning.
- d. In order to avoid the DR process being repeated with unnecessary frequency, there is also a minimum longevity for DR results of 1 month. The only exception to this is for the Temporary Collateral Adjustment method, where because of its simplicity it may be practical and desirable for the parties to use this method more often, up to daily.
- e. The longevity standards above are predicated on stable market conditions and constant portfolio structure. However, if there is a significant market movement that a party reasonably believes would materially affect the outcome, or if there is a significant portfolio lifecycle event (e.g. large payment), then either party can accelerate the defined longevity upon 1 business day notice, bringing that DR cycle to an end and permitting another one to commence.

## **6 Reporting**

## 6.1 Statistical Reporting

[See Outline Section](#)

### 6

- a. There was a proposal to establish a standard set of metrics in order to facilitate comparison of performance, however this has yet to be agreed. The following are a list of suggested metrics for discussion purposes only.
  1. Count per month of margin calls that are disputed and enter Step 1 (include overlapping disputes relating to calls made of different days)
  2. For each such dispute event, the Step in which resolution occurred (ie Step 2, 3, 4a, 4b or Intractable) , its Age at the time of resolution and the method of resolution (ie 4a-1, 4a-2, 4a-3, 4a-4, 4b-1...etc)
  3. For each counterparty, the count per month of dispute events occurring and the percentage of margin calls disputed.
  4. Count per month of Trades Under Investigation, Trades Under Dispute Resolution and Intractable Trades at any time during the month (include duplicates from overlapping disputes)

## 7 Implementation Considerations

### 7.1 Phased Implementation Plan

[See Outline Section](#)

#### 7

- a. It is proposed to implement the DR Protocol in a phased manner. This has the advantage of significantly improving industry practice and structure from the current standards by implementing Steps 1 to 4a, while permitting further consultation around the more material and complex changes to market practice envisaged in Step 4b in particular
- b. A phased approach will also allow firms to ensure adequate internal and external procedures are in place, with proper metrics for monitoring progress, and provides for a bedding in period of time where the process 'noise' can be reduced
- c. This phased approach will also provide firms and regulators with a chance to determine the volume and effort required for each step as well as allow time for the industry to establish the infrastructure required in the later steps (eg, the procedures for Panels and Experts in Step 4)
- d. Further, by bedding in Steps 1 to 4a it will allow market participants to perfect those processes and resolution methods such that future resort to Step 4b methods becomes the rare occurrence that it is intended to be.
- e. In the interim prior to Phase 2, the parties would continue to have access to third party methods of resolution, including both the old "Dealer Poll" mechanism and the new methods described under Step 4b, as they may mutually agree pursuant to the broad "freedom to contract" provisions of 4a-4.

### 7.2 Options for Implementation of Phase 1

- a. There were several options discussed regarding the actual implementation of Phase I which ranged from implementing the proposal as a formal legally binding protocol to a best practices document. In summary there are 3 basic options that have been proposed.
- b. ISDA Protocol - Adherents to the protocol would agree to incorporate Phase 1 steps/ procedures with all other counterparties who adhere to the Protocol. (This would follow the model of the "Big Bang" protocol.)
  1. Protocol would incorporate Phase 1 steps/procedures in a new Paragraph 5 of the CSA which would retain the existing dealer poll in the event that the Phase 1 steps/procedures fails to resolve the dispute. (Basically, Phase 1 would replace the requirements of the existing Para. 5 up to the "Resolution Time" at which point the existing procedures of Para. 5 would kick back in.)
  2. Protocol would replace the existing Paragraph 5 of the CSA with Phase 1 steps/procedures. This is probably unacceptable to both buy and sell side as it provides no path to resolution of unresolved valuation disputes and thus no opportunity to early terminate agreements where such disputes persist.

3. Could provide for Opt-Out, whereby a party may adopt the protocol as above but stipulate to exclude certain counterparties (by class or individually), which could then be addressed bilaterally (see below) or retain the current CSA wording.
- c. Bilateral form of Amendment - Publication of the amendment would permit parties to bilaterally amend their existing CSAs to incorporate Phase 1 steps/procedures on an individual counterparty-by-counterparty basis. The amendment and protocol described in A above are not mutually exclusive. The amendment would be available to parties who prefer for whatever reason to selectively amend their agreements with some, but not all, counterparties.
  1. Amendment would incorporate Phase 1 steps/procedures in a new Paragraph 5 of the CSA which would retain the existing dealer poll in the event that the Phase 1 steps/procedures fail to resolve the dispute. (Basically, Phase 1 would replace the requirements of the existing Para. 5 up to the "Resolution Time" at which point the existing procedures of Para. 5 would kick back in.)
  2. Amendment would replace the existing Paragraph 5 of the CSA with Phase 1 steps/procedures.
- d. Phase 1 as "Best Practice" - Under this approach, Phase 1 would be published as "best practice" rather than as proposed amendment to Para. 5 of the CSA. This might be viewed as a desirable interim step pending agreement on Phase 2 so as to avoid having to amend the CSA twice.
  1. One potential difficulty with this approach is that parties electing to follow the Phase 1 steps/procedures could be viewed as waiving their contractual rights under Paragraph 5 of the CSA. In a recent case, VCG Special Opportunities Master Fund Ltd. v. Citibank, NA, the court ruled that a party which failed to exercise its rights under Paragraph 5 of the CSA had waived its right to contest a call for collateral. The potential problem here is that the Phase 1 steps do not completely conform in substantive and timing respects to the initial steps contemplated by Paragraph 5. Accordingly, it may be necessary for the parties electing to follow the Phase 1 steps to agree that they are not thereby waiving their right to require a dealer poll under Para. 5. A form of waiver to this effect could be prepared and attached as an appendix to the Phase 1 "best practices." It would only need to be adopted at such time as the parties find themselves in a valuation dispute and want to follow the Phase 1 steps/procedures rather than the initial steps contemplated by Para. 5 to resolve the dispute.

**7.3 Timeline for Completion of the Dispute Resolution Proposal**

- a. An outline for Phase 1 of the DR Protocol was published on June 2, 2009. A public comment period has started and will end on June 19, 2009.
- b. An outline for Phase 2 will be published on June 30, 2009 with a public comment period (of length to be determined) to follow.

PROPOSED TIMELINES			
Phase	Exposure Draft Published	Comment Period	Implementation Period
Phase 1 (Steps 1,2,3,4a)	May 31, 2009	+ 3 weeks	TBA
Phase 2 (Step 4b)	June 30, 2009	TBA	TBA

- c. Upon receipt of comments, the DR Protocol and DR Definitions would be finalized, circulated for review and an implementation timeline agreed between certain market participants (including the Fed 16 firms and key buy-side institutions) and the supervisory community.
- d. A market-wide solution for improved resolution of disputed margin calls will be completed by September 30, 2009, with an implementation schedule to follow.

**8 Topics of Discussion**

**8.1 Scope of Use**

- a. The DR Protocol and DR Definitions are intended for use with the ISDA family of credit support documents.

- b. However, it has been suggested that they could be used with other forms of collateral agreement, possibly via short “adaptor” documents that conform the language of the DR documents to other forms of collateral agreement.
- c. This would permit the possibility of common DR process and practice across multiple product sets.
- d. It would also permit the possibility of umbrella DR process spanning cross-netted collateral agreements of the type noted earlier, thus simplifying and de-risking disputes in these complex cases.
- e. This topic is one for future investigation.

## **8.2 Resolution of Margin Disputes versus Pre-Emptive Avoidance**

- a. This proposal focuses on a new industry process for the timely and certain resolution of margin disputes when they occur.
- b. However, it is critical that separate focus be applied to preventing the occurrence of disputes in the first place
- c. This can be achieved by several means:
  - 1. Processing transactions via clearing house mechanisms, where eligible
  - 2. Improving the trade confirmation process to detect and correct booking errors more rapidly
  - 3. Increased use of electronic means to communicate between counterparties and thus reduce the scope
  - 4. Agreement on the use of Common Reference Price Sources - see Section 5.2 for further discussion of this idea
- d. These are outside the scope of this document, but are being pursued through other industry efforts.

## **8.3 Valuation Basis for Collateral Purposes**

- a. It is noted that the DR proposal does not amend in any way the definition of Exposure under the CSAs.
- b. Specifically, this means that when calculating margin calls, or when a Panel or an Expert is engaged to perform dispute resolution, the definition of Exposure applies and all values computed must be on a mid-market, mark-to-market basis.

## **8.4 Disputes Regarding Collateral Value**

- a. It should be noted that although the language in this proposal is mainly drafted from the perspective of disputes regarding the value of underlying derivative positions, it is intended to also cover disputes relating to the value of collateral assets.
- b. In practice, since most collateral is cash, and non-cash collateral tends to be fairly readily valued (eg government securities, agency securities, etc); the incidence of disputes over collateral value is rare.
- c. If and when the plain English of this proposal is converted to formal legal language, it will be made clear that the mechanism applies to all causes of disputed margin calls.

## **8.5 Accounting Treatment**

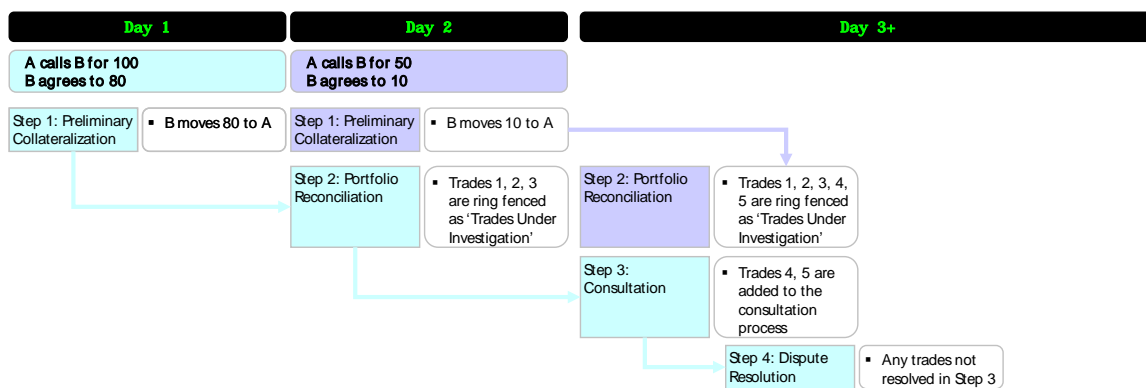
- a. Temporary Collateral Adjustment (TCA) specifically addresses the overall portfolio level collateral requirement, not the value of any specific underlying trade(s). Therefore no adjustment to individual trade values should be made by either party as a result.
- b. All other methods operate at the level of individual trade(s). Each party should continue to maintain its own books and records value for every trade in the portfolio, which may or may not be similar to the DR result and the value used for collateral calculation purposes. Under applicable accounting standards, a party may or may not be required to use the DR result as an observable input to their fair value determination process.

## **8.6 Handling of Overlapping Dispute Cycles**

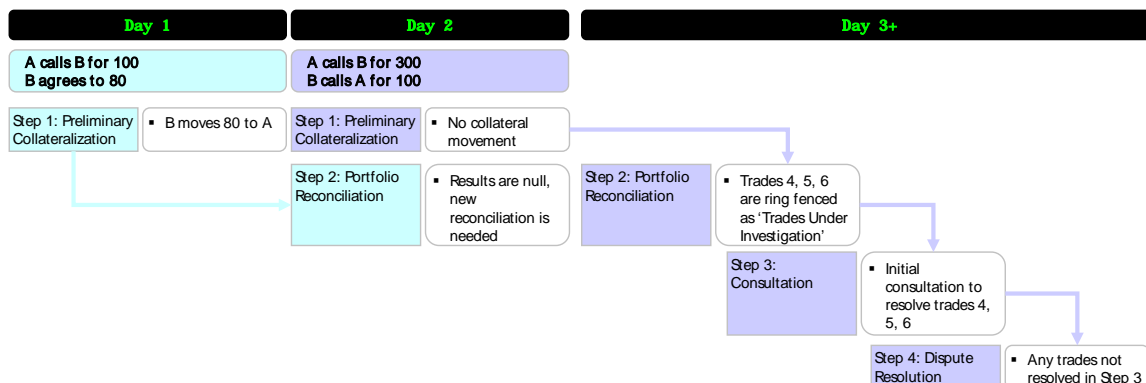
- a. If a margin call has been disputed and is being resolved via Steps 1 to 4, a subsequent margin call may
  - 1. Also be disputed for what are suspected to be the same underlying reasons

2. Be disputed but after significant portfolio changes that may indicate some other or additional operative cause
  3. Be agreed
- b. In all cases (1) and (2) above, Step 1 should be repeated and revised Preliminary Collateralization put in place
  - c. In case (1), the portfolio reconciliation part of Step 2 should also be repeated regularly, with the purpose of checking that there are no new trades with significant differences above the Tolerance that need to be investigated. If there are such new differences, they should be incrementally added to the existing set of Trades Under Investigation.
  - d. In case (2), it may be appropriate to proceed as above, but the parties should consider whether the portfolio has changed sufficiently as to warrant a repeat of Step 2 and complete refresh of the set of Trades Under Investigation.
  - e. In case (3), the parties will need to take a view on whether the underlying causes of the dispute have been spontaneously resolved, in which case further pursuit of the dispute resolution process may be unnecessary; or whether the agreement of a margin call is essentially coincidence and the underlying portfolio differences remain, in which case the process should be continued.
  - f. Example scenarios where a Margin Call has been disputed, Parties have started the Dispute Resolution Steps, and a subsequent margin call is made which is also disputed

1. *Figure: Scenario 1 - Same underlying reasons. Trades are added to Step 3 as identified thru each reconciliation.*



2. *Figure: Scenario 2 - Appears that significant portfolio changes have occurred. Results from previous reconciliation are not used*



**9 Margin Dispute Scenarios**

## **9.1 Disputes in Close Proximity to Default Events**

- a. A disputed margin call in close proximity to a default event is a high risk situation, because the dispute may freeze the collateral balance between the parties (if there is no Undisputed Amount) and thus exacerbate the eventual loss given default.
- b. The DR process will ensure that the Undisputed Amount (if any) is agreed for settlement by the end of day T, and thus will minimize the potential impact of the dispute if a default event subsequently occurs in close proximity.
- c. The DR process will also ensure parties complete steps 1 through 4a within 8 days (and in practice probably much quicker in many cases) or have the ability to accelerate timelines as needed, which also reduces the impact of a default event that occurs in moderate proximity to the dispute.
- d. However, it must be noted that the calling party will be exposed for the difference between their collateral call (or recall) and the Undisputed Amount for the duration of the DR process. This risk cannot be eliminated mechanically by the DR process.
- e. It is recommended that parties consider whether this risk may warrant some hedging or reserving action under certain circumstances. Firms subject to capital adequacy rules may be required to hold increased regulatory capital against such exposures uncovered by collateral.
- f. The industry may also wish to consider whether an Escrow Rider to the DR Protocol might be adopted by parties (either universally or optionally\*) which would provide for:
  1. In the event that a collateral dispute is on-going and in the process of resolution through the DR Protocol, then if not resolved by the [XX]th day then each party shall settle to an agreed escrow agent the additional delivery or return of collateral being claimed by the other party (if any), to be held by the escrow agent until the dispute is resolved, at which point it would be released to the party that prevails in the DR Process.
  2. \* In which case the Escrow Rider would apply only as between parties each of which had adopted it
- g. Such an Escrow Rider would provide an increased financial incentive for both parties to resolve the difference rapidly and importantly, may create additional protection against a proximate default event. It would, however, create an increased funding burden for firms, especially in cases of margin call and counter-call.

## **9.2 Call and Counter-Call Situations**

- a. If both parties A and B are simultaneously calling collateral from each other (a so-called Collateral Call Deadlock), then there is no Undisputed Amount.
- b. This is similar to the situation under the current CSA language, but the Undisputed Amount concept cannot resolve Collateral Call Deadlocks mechanically
- c. Note that the Mid-Point Collateral Amount Methodology (described earlier) is capable of resolving this situation mechanically, but only at the cost of one or both parties needing to deliver collateral in excess of what their risk management calculations indicate, without any supporting evidence to support that act; this was deemed not to be prudent as it potentially increases the exposure of one or both firms
- d. However, unlike the current CSA language which essentially becomes inoperable in case of a Collateral Call Deadlock, the proposed DR process continues to operate and will resolve the situation.

## **9.3 Disputes in the Context of Cross-Netted Collateral**

- a. In some instances there may exist a cross-netting agreement between a pair of counterparties that connects an ISDA CSA and some other collateral agreement, for example a Prime Brokerage Agreement, a GMRA or another document.
- b. In these contexts the interplay between the agreements and the DR process may be complex.
- c. There are 2 main scenarios that could exist at a point in time

1. A - The collateral requirement under the CSA is partly or wholly satisfied by an excess of collateral under the other agreement
  2. B - The collateral requirement under the other agreement is partly or wholly satisfied by an excess of collateral under the CSA
- d. Note that the DR process applies only to the CSA (although see next page regarding Scope of Use).
- e. Therefore in scenario A, the excess value under the other agreement is simply counted as eligible collateral under the CSA and in the event of a dispute under the CSA the DR process as outlined will operate unaffected by the status of the other agreement.
- f. In scenario B, the DR process to resolve the dispute under the CSA will operate as outlined. However, under the other agreement, which is relying on the value of excess collateral held under the CSA, it is critical that value for that excess is allowed only up to the more conservative of (a) the Undisputed Amount or (b) if the parties are in a call versus counter call situation, where there is no Undisputed Amount, then the excess collateral for the purpose of cross-netting should be calculated assuming the most adverse outcome of DR for the party concerned.
- g. If disputes exist simultaneously under both the CSA and the other agreement they will be resolved each according to the applicable dispute resolution rules under the agreement concerned.

## 10 Other Topics of Interest

### 10.1 Collateral Escrow

- a. Although not covered in the final version of the DR Protocol, the topic of escrow did receive consideration during its development. The use of Escrow for collateral amounts subject to dispute was suggested.
- b. Escrow could be triggered after some time certain (e.g. XX days as illustrated in section 9.1 - f), upon some event or condition (e.g. a party below investment grade credit rating) or could be used as a matter of course for all disputed margin calls.
- c. Escrow has several significant benefits:
  1. Deals with the issue of disputes close to default
  2. Deals with the issue of Collateral Call Deadlocks
  3. Reduces the risk that a party prevailing in a dispute may not receive collateral due
  4. Creates earlier transparency to any liquidity issues that a party may be obscuring via margin call disputes
- d. Escrow also has some material disadvantages:
  1. Creates significant operational complexity (as collateral for a counterparty is now to be settled and held via at least two and probably more accounts at different custodians)
  2. Adds cost of escrow fees
  3. Imposes an additional liquidity burden on firms posting collateral to escrow who then prevail at dispute resolution, with an associated cost of carry
- e. For consideration by the working group it is suggested that collateral escrow could be agreed as a potential aspirational goal for further study, that (if agreed) could be layered on top of the core DR Protocol at a later date.

## 11 Appendix

### 11.1 Industry Participation in the DR Working Group

- a. The draft proposal for the DR Protocol was developed by a working group led by the ISDA Collateral Committee, under the auspices of the ISDA Board of Directors. It included representatives of several major disciplines - legal, risk managers, trading and collateral practitioners - across both dealer firms and buy-side firms, and including legal and technology service providers to the industry.

b. The firms listed in the table contributed to the working group

Firm	Company	Firm	Company
Fed 16	Bank of America Barclays BNP Paribas Citi Credit Suisse Dresdner Deutsche Bank Goldman Sachs HSBC JP Morgan Merrill Lynch Morgan Stanley RBS SocGen UBS Wachovia	Other	Allied Irish Banks BAU Post BlackRock BNY Mellon Bridgewater Associates Capital One Cheyne Capital Citadel Commerzbank DE Shaw Ellington Management Group, LLC Fidelity Investments Trade Operations GE Financial Markets Gunvor International BV Handelsbanken Capital Markets HBK ING Bank Ionic Capital KingStreet LaCrosse Global Fund Services Mizuho Moore Capital National Bank of Greece Nochubank Nomura Ontario Teachers' Pension Plan Paloma Partners Management Company Prudential Global Funding LLC Putnam QIC Rabobank SAC Capital Advisors LLP Standard Bank of South Africa Standard Chartered State Street Union Bank of California UniCredit Group VTB Wellington West LB
Legal	Allen & Overy Alston & Bird Baillie Gifford Baker & McKenzie Bell Gully Freshfields Harry Jho LLP Jeffries Linklaters Lloyds TSB Macquarie McCann Fitzgerald Purrington Moody Weil Schulte Roth & Zabel LLP Sidley Austin Sutherland WilmerHale Fried Frank Teigland-Hunt LLP		
Vendor	Allustra DCG Consultants Euroclear Lombard Risk Markit Sungard Collateral Management Trioptima		