

Memorandum

Independent Amount Segregation: Summary of ISDA's Sample Tri-Party IA Provisions

The International Swaps and Derivatives Association Inc. (“**ISDA**”) has published the following documents in order to provide market participants with sample terms and provisions that may facilitate the negotiation of contractual arrangements that provide for segregation of Independent Amounts (“**IA**”) with a third party custodian (collectively, the “**Sample Tri-Party IA Provisions**”). These documents include:

- Form of Amendment to the 1994 ISDA Credit Support Annex subject to New York Law that addresses the segregation of IA with a custodian;
- Sample Pledgor Access Provisions for possible inclusion in a tri-party control agreement; and
- Sample Notice of Exclusive Control Provisions for possible inclusion in a tri-party control agreement.

Each of the foregoing sets of suggested provisions includes various options, the selection of which is left to the parties. It is anticipated that additional sample provisions for tri-party control agreements will be published in the future.

The Sample Tri-Party IA Provisions were drafted primarily in response to new regulations being promulgated under the Dodd-Frank Act in the United States. Specifically, the Sample Tri-Party IA Provisions attempt to provide some initial suggested provisions pending full implementation of the reforms mandated by Section 724(c) for uncleared swaps and the analogous requirement for uncleared security-based swaps contained in Section 763(d) of the Dodd-Frank Act. These sections require dealers to provide their counterparties with the option of having the IA that they post held with a third party custodian. Market participants in other jurisdictions are advised to consult with their local legal counsel and any other advisors/consultants they deem appropriate before attempting to adapt the Sample Tri-Party IA Provisions for use in jurisdictions outside the United States.

It should be noted that the Sample Tri-Party IA Provisions are appropriate only in the context of IA delivered between two parties to a non-cleared OTC derivative contract. Cleared contracts are outside the scope of these sample provisions and would be governed by the applicable clearing house rules that govern IA deliveries and custody.

Capitalized terms not defined in this Memorandum have the meanings ascribed to them in the 1994 ISDA Credit Support Annex subject to New York Law (the “**NY CSA**”).

1. BACKGROUND

A. IA White Paper

Risks associated with IA and the recent regulatory responses to this issue have given rise to more frequent requests for segregation of IA in recent years. In March 2010 ISDA, in conjunction with the Securities Industry and Financial Markets Association (“**SIFMA**”) and Managed Funds Association (“**MFA**”), released a white paper which recommended in part that ISDA, SIFMA, MFA and market participants “develop standard provisions that may be incorporated into documents for Third Party Custodian and Tri-Party Collateral Agent IA holding arrangements” (the “**IA White Paper**”, available at http://www.isda.org/c_and_a/pdf/Independent-Amount-WhitePaper-Final.pdf). A working group comprised of representatives of ISDA member firms (including swap dealers, buy-side firms and custodian firms) was formed in direct response to this recommendation (the “**IA Working Group**”). The IA Working Group focused primarily on the fundamental contractual provisions of a tri-party custody arrangement, and the Sample Tri-Party IA Provisions are the result of these efforts. For certain of the key contractual provisions, there are various options provided to address a particular issue, and the range of options is reflective of the diverse views of the members of the IA Working Group. The Sample Tri-Party IA Provisions should not be taken as representing the views of any one ISDA member firm or group of firms or the whole or any segment of the derivatives market.

B. Summary of Alternative Holding Arrangements for IA

As discussed at length in the IA White Paper, a range of alternative holding arrangements for IA are available for firms to bilaterally negotiate depending on risk and cost appetites and regulatory constraints. The various alternatives can be categorized based on the three primary ways in which IA may be held: (i) direct holding, in which the IA is delivered by the pledgor to the secured party, and the secured party holds the IA itself or through an affiliated entity, (ii) third party custody, in which an unaffiliated bank, broker-dealer or other party operates under an agreement with one of the two counterparties and provides typical custody and safekeeping services, and (iii) tri-party custody, in which an unaffiliated bank or other party providing tri-party custodial services operates under a three-way contract between it and the two OTC derivatives counterparties and agrees to release collateral to the counterparties based on pre-defined conditions.

C. Tri-Party Custody Arrangements

A tri-party custodial arrangement consists of a tri-party control agreement among the pledgor, the secured party and the custodian and sets forth the custodian’s obligations to comply with the instructions of the parties with respect to the collateral in the account based on negotiated parameters. A tri-party control agreement may specify, for example, events upon which a pledgor may seek return of the IA and thereby limit or terminate the secured party’s access to the

IA; the timing of the return of IA to the pledgor when events arise entitling the pledgor to a return of IA; and the amount of IA that may be returned to a pledgor upon the occurrence of events entitling the pledgor to such a return. Because such tri-party control agreements frequently require time-consuming negotiations among the three parties and also require amendment of the NY CSA, the proposed Sample Tri-Party IA Provisions are intended to facilitate the negotiation process by providing a form of amendment to the NY CSA along with suggested language that may be incorporated into tri-party control agreements as the parties see fit.

D. Secured Transactions Issues Arising Under a Tri-Party Custody Arrangement

Under a tri-party custodial arrangement, as in all other models for holding collateral, the secured party will seek to ensure that it obtains and continues to have a perfected security interest in the collateral. Obtaining a perfected security interest is not only necessary to protect the secured party against competing claimants, but may also be relevant to the analysis of regulatory requirements that are applicable to the secured party.

For collateral consisting of cash and investment property held in a tri-party custody arrangement with a U.S. financial institution, the perfection of the secured party's security interest would generally be governed by the applicable Uniform Commercial Code (the "UCC"). Although there are various options available to secured parties wishing to obtain a perfected security interest, secured parties typically seek to perfect by "control" within the meaning of the UCC. In the tri-party holding model, however, achieving a perfected security interest by "control" is often more complicated than in either the direct holding arrangement or the third party custody arrangement (described in B(i) and (ii) above) because the custodian holding the collateral typically has duties to both the pledgor and the secured party. Although the UCC has been adopted in whole or in part in all 50 states in the United States and is largely uniform, some variations exist, and questions may arise as to whether, in a particular transaction, after giving effect to the elections and other agreements negotiated by the parties, "control" has been achieved by the secured party under the UCC. Given the complexity of this area of law, secured parties are strongly advised to consult with their legal advisors and any other advisors/consultants they deem necessary if they intend to use a tri-party custody arrangement in order to ensure that they have obtained a perfected security interest.

2. STRUCTURE AND OVERVIEW OF THE SAMPLE TRI-PARTY IA PROVISIONS

Set forth below is a brief description of the purposes and structures of the Sample Tri-Party IA Provisions.

A. Amendment to the NY CSA

Given that a tri-party custodial arrangement for IA requires the separation of IA from the rest of the collateral that may be posted by a pledgor, it is necessary to modify the standard NY CSA to create a separate pool of IA (as opposed to the current language of the NY CSA that produces a single collateral pool that includes IA and other collateral). Parties are provided with several attachments under the Amendment to the NY CSA; however, each attachment is neither necessary nor recommended in every scenario. Parties are advised to apply only the attachments that they believe are appropriate based on their particular circumstances and individual negotiations.

For example, parties should apply either Attachment 6 (“Custodian Risk – Pledgor Liable”) or Attachment 7 (“Custodian Risk – Secured Party Liable”), but not both in order to assign liability associated with the use of a custodian to one party or the other. Furthermore, parties must be mindful of the interaction between the Sample Tri-Party IA Provisions and their control agreement provisions. For example, Attachment 13 (“Secured Party Dispute Right”) and Attachment 14 (“Pledgor Dispute Right”) are intended to allow parties to address dispute rights bilaterally in the NY CSA (if they so choose) as an alternative to including such terms in their control agreement. If either Attachment 13 or Attachment 14 is applied, then a secured party dispute right or pledgor dispute right, respectively, should not be included in the relevant control agreement.

Parties should consult with their legal advisors and any other advisors they deem appropriate prior to using this form of amendment to the NY CSA. Due to the range of modifications parties may have made to their ISDA Master Agreement and NY CSA, modifications to this form amendment may be necessary, or an entirely different form of amendment may be appropriate, depending on the particular agreement.

B. Pledgor Access Provisions and Notice of Exclusive Control Provisions

The Pledgor Access Provisions and Notice of Exclusive Control Provisions are intended as suggested language for parties negotiating terms under a tri-party control agreement. These documents provide optional provisions that mirror each other in structure. The first portion [“X”] of each document provides alternative formulations for accessing IA. The second portion [“Y”] provides optional dispute right mechanics which may be deleted in their entirety and should not be used if the corresponding dispute right mechanics provided under Attachments 13 and 14 of the Amendment to the ISDA NY CSA are selected. The final portion of each document [“Z”] sets forth the defined terms.

3. QUALIFICATIONS

The Sample Tri-Party IA Provisions are intended as suggested language only, and neither the Sample Tri-Party IA Provisions (including any provision or attachment thereto) nor this Memorandum constitutes legal advice or a recommendation to use any provision included therein. Parties are advised to consult with their own legal counsel and other relevant

professionals to obtain appropriate advice concerning the use of tri-party control agreements and any of the provisions included in the Sample Tri-Party IA Provisions. Moreover, ISDA recognizes that the provisions or attachments contained in the Sample Tri-Party IA Provisions are not necessary or appropriate under all circumstances. Consequently, market participants using the Sample Tri-Party IA Provisions should carefully consider the full scope of regulatory and commercial requirements that may apply to their particular circumstances. Market participants should also consult with their legal counsel and any other advisors/consultants they deem appropriate before negotiating revisions to the Sample Tri-Party IA Provisions.

ISDA recognizes that the regulatory environment with respect to IA segregation is still evolving and therefore the Sample Tri-Party IA Provisions may need to be further modified to adhere to and comply with final Commodity Futures Trading Commission and Securities Exchange Commission regulations. ISDA will continue to monitor legislative and regulatory developments in this area and reconvene the ISDA IA Working Group as appropriate to address any such developments.