SUTHERLAND

LEGAL ALERT

March 18, 2010

New ISDA Papers on Collateral Practices

The International Swaps and Derivatives Association, Inc. ("ISDA") recently published two documents prepared by its Collateral Committee in response to requests from regulators. Both documents should be of interest to end-users and other market participants. The documents are available on ISDA's Web site at: http://www.isda.org/c_and_a/collateral.html

The first document, a "Market Review of OTC Derivative Bilateral Collateralization Practices," was undertaken at the request of the U.K. Financial Services Authority on behalf of an international group of OTC derivative supervisors. This document provides an excellent overview of bilateral collateral agreements and practices, and provides explanations of why certain parties do (and others do not) agree to exchange collateral to mitigate counterparty credit risk. The document also contains interesting preliminary data from ISDA's 2010 Margin Survey:

- The survey indicates that 78% of all derivatives trades are subject to collateral arrangements, although the percentage varies considerably according to the underlying asset class (97% of credit derivatives and 84% of fixed income derivatives are collateralized, but only 63% of FX derivatives and 62% of energy and other commodity derivatives are collateralized).
- Eighty-four percent of all collateral agreements are bilateral (i.e., require posting by whichever party is out of the money).
- Collateral in circulation as of December 31, 2009, is estimated to be between $2 and $3 trillion, a significant decline from the $4 trillion estimated for the prior year. The decline is attributed to portfolio compression and lower market volatility leading to lower mark-to-market values for derivatives portfolios.

The second document is a white paper regarding "Independent Amounts" (also sometimes referred to as "initial margin") that was submitted to the Federal Reserve Bank of New York by ISDA, MFA, and SIFMA as promised in the derivative industry letter to the Federal Reserve Bank of New York and other banking supervisors dated June 2, 2009 ("IA White Paper").[1] IA refers to additional amounts above and beyond the net mid-market, mark-to-market value of outstanding trades that the parties typically agree to exchange under the standard collateral agreements entered into in connection with ISDA Master Agreements.

Such amounts are an add-on to the collateral amount that would otherwise be delivered and are intended to provide the secured or receiving party with an additional cushion against potential loss due to a default by the party posting the IA (the pledgor). In almost all cases, IA is posted by end-users (primarily hedge funds and certain other "unrated" end-users) to their dealer counterparties.[2] Dealers almost never post IA to their end-user counterparties or to other dealers.

[1] SIFMA is the Securities Industry and Financial Markets Association; MFA is the Managed Funds Association.

[2] Provisions of the pending derivatives reform legislation would appear to contemplate new regulatory requirements that could result in all counterparties to OTC trades being required to post both initial and variation margin. (See §§ 3107 and 3203 of the Wall Street Reform and Consumer Protection Act approved by the U.S. House of Representatives in December, 2009 (referred to herein as H.R. 4173) and §§ 718 and 754 of the new financial reform bill published this week by Senator Christopher J. Dodd (called the Restoring American Financial Stability Act of 2010). IA is akin to initial margin (generally imposed in the exchange-traded futures

The genesis of the IA White Paper is the fact that upon the insolvency of a dealer holding IA, IA will typically be regarded as an asset of the bankrupt estate and the end-user will simply have a general creditor's claim for the return of its "excess" collateral. The risk to end-users with respect to IA was dramatically demonstrated in the Lehman bankruptcy where general creditors expect to receive only a few cents on the dollar for their general creditor claims related to IA. Stated differently, a valid credit risk mitigation tool employed by the dealers may actually result in a material economic risk for end-users where the dealer, rather than the end-user, becomes insolvent, thus the "IA dilemma." In addition to the risk posed to individual end-users, IA represents a systemic risk because it encourages all the counterparties who have posted IA to a dealer experiencing financial stress to take whatever actions they can to have their IA returned before the dealer becomes insolvent, thus promoting the equivalent of a "run on the bank."

As indicated in the IA White Paper, the "obvious" solution to the IA dilemma is for the IA to be held for the benefit of dealers in an account of an independent third party so that upon the insolvency of the dealer the IA would be returned forthwith to the non-defaulting end-user party who posted the IA. Under such an arrangement, the IA would continue to serve the purpose of providing additional credit protection to the dealer (because the third party custodian would be required to deliver the IA to the dealer upon default by the end-user), but would not be at risk to the end-user in the event that the dealer becomes insolvent. Unfortunately, the dealer community declines to view this as a "win-win" solution to this problem. Rather, they articulate numerous reasons why holding IA under a third party custody arrangement would pose additional costs and risks to dealers and conclude that such arrangements should be but one of several options available to the parties. Stated differently, third party custody arrangements for IA must be negotiated, and the dealers are not committed to offering such arrangements (even with alternative pricing or additional costs) in their dealings with end-users.

To date, end-users have had very little success in negotiating third party custody arrangements with dealers. One reason for this is that there are a number of legal documentation and cost issues surrounding third party custody agreements that need to be negotiated.[3] Some involve issues between the two counterparties and others involve issues between the counterparties and the custodian. Given these challenges, probably the most meaningful part of the IA White Paper is the following recommendation:

> **Recommendation 12 - ISDA, SIFMA, MFA, and market participants should expeditiously work together to develop standard provisions that may be incorporated into documents for Third Party Custodian and Tri-Party Collateral Agent IA holding arrangements. Consideration should be given to applying these standard provisions to the holding of IA by Dealer Affiliates also, where applicable.** [4]

It remains to be seen how quickly the standard documentation contemplated by this recommendation will be developed.

---

markets), and variation margin is akin to the mid-market, mark-to-market value. Thus the "safety" of IA could become an issue for all end-users as the market practice adapts to a new regulatory environment.

[3] See IA White Paper at pp. 7-10, 16-17.

[4] Essentially the same recommendation (absent the word "expeditiously") was included as Recommendation 4 in the Market Review of OTC Derivative Bilateral Collateralization Practices submitted to the FSA.

In contrast to the tone of the IA White Paper, proposed derivatives regulatory reform would address this issue directly. Section 3122 of H.R. 4173, the Wall Street Reform and Consumer Protection Act of 2009 adopted by the House of Representatives this past December, provides as follows:

> **(a) SEGREGATION.—At the request of a swap counterparty who provides funds or other property to a swap dealer initial margin or collateral to secure the obligations of the counterparty under a swap between the counterparty and the swap dealer that is not submitted for clearing to a derivatives clearing organization, the swap dealer shall segregate the funds or other property for the benefit of the counterparty, and maintain the initial margin or collateral in an account which is carried by an independent third-party custodian and designated as a segregated account for the counterparty, in accordance with such rules and regulations as the Commission or Prudential Regulator may prescribe.[5]**

Section 718 of the new financial reform bill published this week by Senator Christopher J. Dodd (called the "Restoring American Financial Stability Act of 2010") would also provide segregation rights to parties pledging IA.[6] As indicated earlier, the risks associated with IA may not be limited to hedge funds if the pending derivatives regulatory reform legislation becomes law. IA may become routine for all end-user participants in the OTC market. In this case, the need for a legislative "fix" will be even more apparent.

■ ■ ■

If you have any questions regarding this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

James M. Cain	202.383.0180	james.cain@sutherland.com
Paul B. Turner	713.470.6105	paul.turner@sutherland.com
Peter H. Rodgers	202.383.0883	peter.rodgers@sutherland.com
Warren N. Davis	202.383.0133	warren.davis@sutherland.com
William H. Hope II	404.853.8103	william.hope@sutherland.com
Robin J. Powers	212.389.5067	robin.powers@sutherland.com
Doyle Campbell	212.389.5073	doyle.campbell@sutherland.com
Richard E. Grant	202.383.0909	richard.grant@sutherland.com
Meltem F. Kodaman	202.383.0674	meltem.kodaman@sutherland.com
Mark D. Sherrill	202.383.0360	mark.sherrill@sutherland.com

[5] Section 3203 of H.R. 4173 provides the same rights with respect to security-based swaps.
[6] Section 754 of Senator Dodd's bill would provide these right with respect to security-based swaps.