



ISDA publishes new dispute resolution procedures for collateral calls in derivatives markets

Dec 21 2009 [Lauren Teigland-Hunt](#), [Ryan Patino](#), [Joshua Riezman](#)

Procedures currently in "Experimental Pilot Program" stage; market-wide implementation to occur mid-2010

Background

In order to satisfy recent industry commitments to regulators, the [ISDA Collateral Committee](#) recently published the 2009 Collateral Dispute Resolution Procedure (the "DR Procedures"), a comprehensive set of procedures that are intended to improve the way in which collateral call disputes in OTC derivatives markets are resolved. The DR Procedures were developed by the ISDA Collateral Committee in consultation with other ISDA committees and trade associations representing buy side market participants and were submitted to the Federal Reserve Bank of New York and other market regulators on September 30, 2009.

The DR Procedures are currently being tested by several dealer and buy-side firms as part of an experimental pilot program, with broader market-wide implementation expected to take place in 2010. Although ISDA's credit support annexes (or CSAs) already contain standard [dispute resolution provisions](#) for collateral calls, the DR Procedures seek to improve upon these provisions as well as other processes currently used in the marketplace to resolve collateral call disputes in response to concerns raised by regulators in 2008. Specifically, the DR Procedures aim to:

- create consistent and predictable processes, timing and behavior for addressing disputes across the market;
- ensure timely portfolio reconciliation in order to identify root causes of disputes; and
- establish a fair and definitive fallback methodology for resolution in the event the parties are unable to mutually agree how to resolve their differences.

ISDA's DR Procedures: four key steps

Step 1: preliminary collateralization

Consistent with the approach embodied in the existing CSAs, this step requires the "undisputed" amount of collateral to be transferred so that the calling party is provided with some protection pending resolution of the dispute.

Step 2: portfolio reconciliation

This step requires the parties to exchange portfolio details in order to reconcile their portfolios and identify the causes of the dispute. Where trades have valuation differences that exceed a certain "tolerance level" or are unmatched, they are labeled "transactions under investigation," and the parties proceed to the next step.

Step 3: consultation and informal dispute resolution

As part of this step, the parties are expected to consult with each other and internally within their firms to assess transactions under investigation and attempt to identify any administrative or operational errors that have contributed to the dispute. For transactions not resolved by the administrative review and consultation process, the parties may elect one or more of the following informal/mutual resolution methods:

- Temporary collateral adjustment
- Common reference pricing
- Mutually agreed exit of position

- Other resolution method (as mutually agreed)

Each of these methods is elective and may be used only upon mutual consent of the parties. If the parties do not agree to resolve their dispute using one of these methods, they are mandated to apply the formal dispute resolution method described in Step 4 for remaining transactions under investigation.

Step 4: formal dispute resolution — market polling

This step is intended to produce a "market-based determination" of the value of a transaction under investigation. Formal dispute resolution effectively relies on the conduct of a "market poll" to resolve a valuation dispute and, in that regard, is similar to the existing CSA dispute resolution provisions. However, there are several key distinctions:

Quote gathering and evaluation

Commercially reasonable efforts: Both parties to the trade are expected to use commercially reasonable efforts to obtain quotes for disputed trades.

Priority: Prices published by clearing houses for a particular product or instrument are deemed to be presumptively correct. Two-way, firm executable prices are given priority over any indicative prices.

Market-making party v. rebutting party: If a party to the trade is a reference independent price source (RIPS, defined below), then its two-way, firm executable quote (a "market-maker quote") will be included as part of the market poll. A RIPS is a financial institution that (a) regularly maintains an executable, two-sided market consisting of a simultaneous bid and offer for a traded quantity of the product in question, or in the case of illiquid instruments, is willing to make an executable, two-sided market for an extended and commercially reasonable period of time; and (b) is of reputable credit quality. The term "financial institution" includes not only registered banks, brokers or dealers but also investment funds with more than \$100m in investable assets that are managed by a manager that is either registered or operating pursuant to an exemption.

Spread-based moderation: If a single party to a disputed trade provides a market-maker quote and no third party firm quotes are available, the DR Procedures set out a two-step averaging process that attempts to give equal weight to the opinions of the two parties and the composite market opinion expressed by the indicative quotes received (if any). Specifically, the valuation that prevails will be based on the average of (a) the mid-point of the two-way market-maker quote (b) the rebutting party's mid-market value, and (c) the average of all indicative reference quotes; however, that resulting valuation will be capped (or floored) at the market-maker's offer (or Bid).

Standards for quotes

Permissible sources: All quotes must be provided by parties that are RIPS or clearing houses and must state any limitations as to their validity, including but not limited to date, time, size and any relevant benchmark levels in the market used to determine the quote. In addition, the DR Procedures prescribe that quotes should be obtained without taking into account the credit quality or identity of either of the parties.

Commercially reasonable spread: All two-way quotes must have a commercially reasonable spread for the product and the market conditions at the time. Additionally, the spread may not exceed the amount stated for the transaction type in question in any "maximum stressed spread table" that may be published by ISDA from time to time (or, if greater, the maximum spread previously agreed between the parties).

Executable: All parties providing two-way quotes must post them in a public venue and be willing and able to stand behind their quotes, subject to commercially reasonable credit, legal and regulatory due diligence.

Formal dispute resolution timing: three-stage process

1. *Polling process consultation:* Within two local business hours, each party affirms its role as either rebutting party or market-making party and identifies to the other party the pricing sources from which it intends to solicit quotes.
2. *Quote gathering:* This stage starts upon the completion of the polling process consultation and generally lasts eight local business hours – or 16 hours if the parties are trans-continently dispersed. There is no limit to the number of quotes that each party may obtain and submit.

3. *Quote evaluation:* Once quote gathering has been completed, within eight local business hours, each party is to disclose all of the quotes made or obtained by them (if any), and quotes are then collated into the following categories: (a) two-way firm, executable (b) two-way indicative, or (c) mid-market, indicative. The collated quotes are then evaluated and a result is determined based on the applicable scenario and standards set forth in the DR Procedures. For example, if quotes are obtained from a clearing house, quotes from other sources are disregarded. If there are no clearing house quotes but two-way, firm, executable quotes are obtained from third parties, then indicative quotes are disregarded.

Other key points to note

The DR Procedures make a number of other material changes to the approach reflected in the dispute resolution provisions of the existing CSAs, including the following:

Longevity of results. The DR Procedures provide that results obtained through their application will continue to be used for the purpose of computing collateral demands between the parties until such time as the relevant markets move or additional transparency of fair value develops.

Consequences of failure to perform. The DR Procedures also provide that if a party fails to perform the actions required of it within the prescribed time periods and such failure is not remedied within two local business hours after written notice of such failure, then their calculation or dispute of the collateral amount due will be disregarded, and the calculation or opinion of the other party will stand as the result with respect to the relevant transactions.

Anticipated implementation and key dates

The DR Procedures are lengthy and deal with a highly complex, cross-disciplinary and sensitive part of market practice. Consequently, ISDA has provided that the DR Procedures should be implemented in three stages.

1. *Experimental pilot program:* October 15 – December 15, 2009

During this brief test period, several volunteer firms have agreed to apply the DR Procedures to actual and hypothetical disputes on a non-exclusive basis to detect and correct any obvious deficiencies with the procedures.

2. *Trial period:* January 15 – June 15, 2010

Starting in January 2010, the major derivatives dealers are to engage in an extended trial of the DR Procedures, with voluntary participation by other firms. During this period, the DR Procedures will replace existing dispute resolution procedures, but parties will be allowed to fall back to their existing contractual documentation if they wish.

3. *Market adoption:* July 15, 2010 onward

The formal adoption of the DR Procedures by market participants broadly is expected to take place during the summer of 2010. Exact details of this stage of implementation will be developed based upon the experience of the earlier stages.



TEIGLAND-HUNT LLP

Lauren Teigland-Hunt's practice focuses on derivative, securities and commodity transactions and US commodities law and regulation. She has extensive experience representing financial institutions, hedge funds, exchanges and trade associations in a wide range of trading matters, with a focus on equity, credit, fixed income and commodity derivatives as well as transactions in physical energy. She also advises on regulatory issues related to derivative transactions and acts as counsel to several ISDA drafting committees and the Derivatives Subcommittee of the Managed Funds Association.

Prior to founding Teigland-Hunt LLP in 2002, Lauren was an attorney at Sullivan & Cromwell LLP in the firm's Commodities, Futures and Derivatives Group.

Ryan Patino originally joined Teigland-Hunt LLP in June 2004 as a law clerk and became a full-time associate in 2006. Since 2004, Ryan has acquired substantial experience in derivatives and commodities trading documentation, including ISDA Master Agreements, Master Repurchase Agreements, Global Master Repurchase Agreements, FFI Master Power Purchase & Sale Agreements, prime brokerage

documents and NAESB Base Contracts for Sale and Purchase of Natural Gas. Ryan also has performed industry research and analysis for trade associations and hedge funds and drafted memoranda addressing issues arising under US derivatives and commodities laws as well as investment adviser regulation.

Joshua Riezman joined Teigland-Hunt LLP in June 2007. Joshua has experience drafting and negotiating derivatives and commodities trading documentation, including ISDA Master Agreements, Master Repurchase Agreements, prime brokerage documentation and master confirmation agreements. He has performed industry research for trade associations, hedge funds and financial institutions, and he has drafted several white papers on industry topics. Joshua also focuses on regulatory and legislative developments in emerging environmental commodity markets.

Explore Complinet

We connect all due diligence, AML and anti-fraud activities with our Global Screening solutions.

We connect your corporate policies with ever changing external rules and regulations using Complinet's online Policy Manager.

We are the leading provider of cost-effective, interactive e-learning programs to over 400 global clients.

Complinet | Connected Compliance TM

© 2009 Complinet Ltd and its contributors. All rights reserved.

[Contact us](#)

[Disclaimer](#)

[Terms and conditio](#)