



Derivatives Litigation Trends & Overview

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**ISDA 26th Annual General Meeting
Documentation and Legal
4:15 PM, Wednesday, April 13th**

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Derivatives Litigation Trends & Overview

- *Lehman* related cases have continued to set precedent in the context of bankruptcy proceedings
- *Continued challenges to the enforceability of ISDA documentation related to marketing and disclosure surrounding trades*
- *Continued documentation disputes over negotiated terms in Schedules, Confirmations & Paragraph [11][13] to Credit Support Annexes*
- Regulatory scrutiny

Derivatives Litigation Trends & Overview

Marketing/Enforceability Issues:	
<i>Alabama Public School and College Authority v. JP Morgan Chase Bank</i> (attempt to void swaption due to lack of authority asserted upon exercise of option)	No. 08CV00863-WKW-CSC (M.D. Al. 2008)
<i>JP Morgan Chase Bank v. Springwell Navigation Company & Ors</i> (dispute over relationship between the parties and whether JP Morgan owed a duty to counterparty)	[2008]EWHC 1186 (Comm)
<i>Murphy-Hoffman Company v. Bank of America, N.A.</i> (negligent misrepresentation, breach of agreement and frustration of commercial purpose over marketing of interest rate swap)	No. 09-00227-CV-W-FJG (W.D. Mo. 2009)
<i>Wells Fargo N.A. v. Sharma</i> (NY jurisdiction upheld in dispute over enforceability of interest rate swap)	No. 2009CV00854 (S.D.N.Y. 2009)
<i>Yountville Investors LLC v. Bank of America, N.A.</i> (negligent misrepresentation, breach of implied covenant of good faith and fair dealing over marketing of interest rate swap)	2009 U.S. Dist. LEXIS 67425 (W.D. Wash., July 28, 2009)

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Marketing/Enforceability Issues (cont'd):	
<i>MBIA Insurance Corporation et al v. Merrill Lynch Pierce, Fenner & Smith Inc. et al</i> (fraud, negligent misrepresentation and breach of contract relating to CDS on CDOs created by Merrill Lynch)	No. 601324/09 (N.Y. Sup. Ct. 2009)
<i>CFIP Master Fund Ltd. v. Citibank N.A.</i> (Breach of contract dispute regarding CDS in synthetic CDO structure)	No. 09CV06197 (S.D.N.Y. 2009)
<i>Wachovia Bank, N.A. v. VCG Special Opportunities Master Fund Ltd.</i> (breach of contract and fraud suit over CDS and VCG initiated arbitration proceedings with FINRA)	No. 10-1648 (2d Cir.)
<i>Sterling Stamos Levered (Offshore) Fund Ltd. v. Deutsche Bank AG</i> (dispute over total return swaps on reference hedge funds)	[case # pending](N.Y. Sup. Ct. 2011)
<i>ILLE Papier-Service GmbH v. Deutsche Bank</i> (dispute over sufficiency of disclosure in marketing of swaps)	Federal Court of Justice of Germany

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ISDA Documentation Issues:	
<i>CDO Plus Master Fund Ltd. v. Wachovia Bank, N.A.</i> (CSA Valuation Agent duty dispute)	No. 2007CV11078 (S.D.N.Y. 2007)
<i>VCG Special Opportunities Master Fund Ltd. v. Citibank, N.A.</i> (CSA amount of collateral dispute)	594 F. Supp. 2d 334 (S.D.N.Y. 2008), aff'd, No. 08-5707, 2009 WL 4576542 (2d Cir. Dec. 8, 2009)
<i>LBSF v. Metavante Corporation</i> (Section 2(a)(iii) issue)	No. 08-13555 (Bankr. S.D.N.Y.)
<i>Marine Trade S.A. v. Pioneer Freight Futures Company Ltd.</i> <i>BVI</i> (Section 2(a)(iii) issue)	[2009] EWHC 2625 (comm)(29 October 2009)
<i>BNP Paribas v. Wockhardt EU Operations</i> (Close-out Amount not a penalty)	[2009] EWHC 3116 (Comm) (3 December 2009)

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ISDA Documentation Issues (cont'd):	
<i>Ambac v. Bay Area Toll Authority</i> (Market Quotation subject to 'commercially reasonable' standard)	No. 2009CV07062, (S.D.N.Y. 2009)
<i>In Lomas & others (together the Joint Administrators of Lehman Brothers International (Europe)(in administration)) v. JFB Firth Rixson, Inc. & others</i> (Section 2(a)(iii) issue)	[2010] EWHC 3372 (ch) (21 December 2010).
<i>Good Hill Master Fund LP v. Deutsche Bank AG</i> (CSA amount of collateral dispute)	No. 10600858, (NY Sup. Ct. April 5, 2010)
<i>Morgan Stanley & Co. Inc. v. Peak Ridge Master SPC Ltd.</i> (dispute over futures contract and failure to maintain margin)	No. 10CV08405 (S.D.N.Y.)

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Structured Finance Issues:	
<i>Lehman Brothers Special Financing Inc. v. BNY Corporation Trustee Services</i> (‘flip-clause’ ipso facto case)	No. 08-13555 (Bankr. S.D.N.Y)
<i>Lehman Brothers Special Financing Inc. v. Ballyrock ABS CDO 2007-1 Ltd.</i> (‘flip-clause’ ipso facto case)	No. 08-13555 (Bankr. S.D.N.Y)
<i>Lehman Brothers Special Financing Inc. v. American Family Life Assurance Company of Columbus</i> (‘flip-clause’ ipso facto case)	No. 08-13555 (Bankr. S.D.N.Y)
<i>Lehman Brothers Holdings Inc. v. Libra CDO Limited</i> (challenged authority of trustee to terminate swap due to indenture provisions and ‘Flip-clause’ ipso facto case)	No. 08-13555 (Bankr. S.D.N.Y)
<i>Perpetual Trustee Company Limited v. BNY Corporation Trustee Services Ltd.</i> (‘flip-clause’ ipso facto case)	[2009] EWCA CIV 1160 (12 Nov. 2009)

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Regulatory Enforcement Issues:	
<i>SEC v. Roresch</i> (insider trading related to a CDS)	673 F. Supp. 2d 217 (S.D.N.Y. 2009)
<i>SEC v. LeCroy, et al.</i> (securities fraud related to BMA Index Interest Rate Swap)	No. 09CV02238 (N.D. Al.)

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Litigation and Amicus Overview

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Swedbank v. LBHI *et al.*

• Facts:

- LBHI was a counterparty and guarantor to various swap agreements with Swedbank and also maintained a Swedish krona general deposit account with Swedbank. Following LBHI's bankruptcy filing, Swedbank placed an administrative freeze on a general deposit account belonging to LBHI. Withdrawals were blocked, but deposits were allowed to continue.
- Swedbank argued that its contractual setoff rights (as protected by the "safe harbor" provisions of the Bankruptcy Code) authorized it to setoff *post-petition* deposits against \$13.9 million owed to Swedbank (and affiliates) by LBHI (as either counterparty or guarantor) under the ISDA Master and additional sums owed under a promissory note.

• Issues Presented:

- Did Swedbank's rights of setoff under the ISDA Master and "safe harbor" provisions allow setoff of pre-petition debts against deposit account funds that were accrued post-petition?
- Did Swedbank's administrative freeze of LBHI's deposit account violate the automatic stay?

Swedbank v. LBHI *et al.*

- The Bankruptcy Court's Decision:
 - Judge Peck held that Swedbank had *no right of setoff* and that its administrative freeze of LBHI's deposit account violated the automatic stay.
 - "Mutuality" is a prerequisite to the operation of contractual setoff rights. Mutuality was lacking because funds in the account were deposited *post-petition*, while LBHI's obligations under the swap agreements arose *pre-petition*.
 - Judge Peck reasoned that the safe harbor provisions allow for a contractual right of setoff under a swap agreement free from stay, but that they simply do not address the Bankruptcy Code's "mutuality" requirement.
 - Stay was violated because Swedbank failed to move promptly for stay relief.

Swedbank v. LBHI *et al.*

- The Appeal – ISDA's *Amicus* Brief:
 - ISDA *amicus* arguments:
 - The plain language of the safe harbor provisions overrides other policy considerations, and exempts the setoff rights found in the ISDA Master from "any provision" of the Bankruptcy Code, including both the automatic stay and the requirement of "mutuality."
 - The Bankruptcy Court should have addressed only whether Swedbank's exercise of non-mutual setoff rights (which were not expressly provided for under the swap agreements) was proper. The Court's overly broad holding—that a "contractual right of offset" generally requires "mutuality"—wasn't at issue, and threatens market stability by calling into question other setoff rights (such as cross-affiliate netting provisions).

Swedbank v. LBHI et al.

- The District Court's Decision on Appeal:
 - Judge Buchwald affirmed the decision of the Bankruptcy Court, *for the reasons set forth by the Bankruptcy Court*. Judge Buchwald further opined:
 - Swedbank's attempted setoff was beyond the scope of the safe harbor provisions, which were intended to protect actions related to termination/liquidation of swap agreements (and not setoff of general commercial obligations with "no connection to the...swaps").
 - The totality of the legislative history supported the argument that Swedbank was allowed to terminate the master agreements and to determine a single net termination value, but *not* to non-mutual setoff against LBHI's post-petition assets. (And, fn.6, there is a "paucity of support" for mutuality by contract.)
 - Swedbank's construction would result in *de facto* super-priority status extending to all of its commercial transactions with LBHI. In light of Congress' silence as to whether it intended to alter the principles of mutuality and priority, it was clear that such status was not intended.
 - Swedbank filed notice of appeal on February 28, 2011.

Lehman Brothers Holding's Inc v. JPMorgan Chase Bank, N.A.

- Shortly before Lehman's insolvency, JPM received from LBHI a secured guaranty of obligations (including swaps) of Lehman subs to JPM and its affiliates.
- Lehman sued to recover collateral as fraudulent conveyance. JPM moved to dismiss. Lehman filed 145-page reply. Numerous claims/questions (fraud, coercion, etc.).
- At stake – \$\$B!!!
- Key issues for ISDA:
 - Is a newly incurred guaranty a protected "transfer" for purposes of the Bankruptcy Code safe-harbors from avoidance?
 - "transfer v. "obligation"
 - legislative policy?
 - Should creditor's intent to take collateral be imputed to debtor as debtor's actual intent to defraud creditors?
 - Process – standards of review and safe-harbor cases.

Lomas v. JFB Firth Rixon

- Section 2(a)(iii) – beyond Metavante, under English law.
- Contractual construction ---> Penalty?

Forfeiture?

“Anti-Deprivation”?

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Litigation and Amicus Overview

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Clearing-related Documentation ISDA's Proposed Master Bridging Arrangement

David Geen
General Counsel
ISDA

Documentation and Legal
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Background

Current and Potential ISDA Clearing Documentation Projects

Current:

- **Master Bridging Arrangement**

Potential:

- **Standard Give-up Agreement (with FIA)**
- **Standard Client Documentation**

The Issue

- **ISDA Master Agreement facilitates netting across all product types – proven risk-reduction benefits**
- The move to central clearing across multiple CCPs for OTC derivatives breaks that up
- Can we stitch it back together to preserve the benefits of cross-product netting?

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A solution?

- A form of master netting agreement?
- Linking cleared and uncleared ISDA MAs ...
- ... and potentially futures-style clearing arrangements

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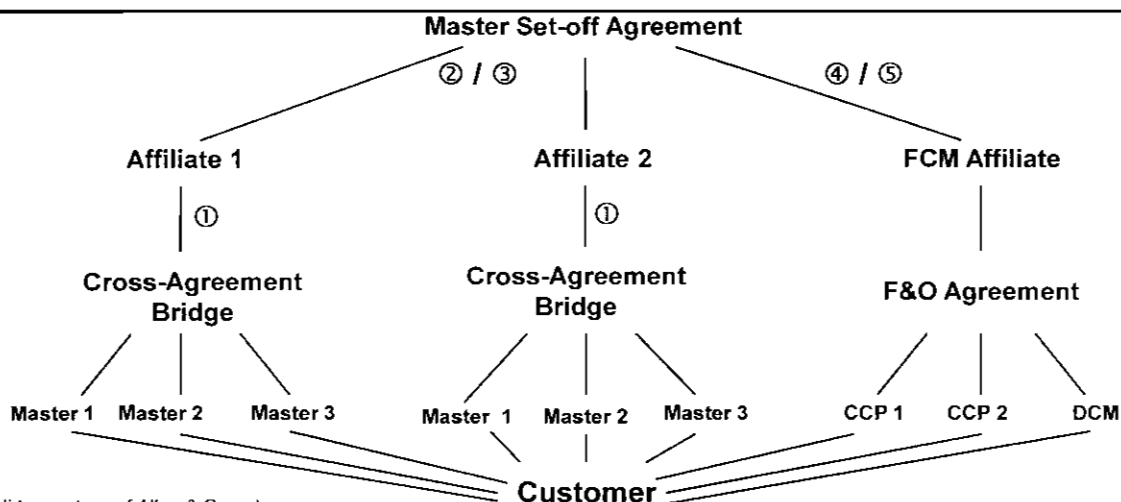
Constraints

- Relationship with CCPs' documentation
- Different CCP models, structures and documents
- Cross-affiliate issues: mutuality
- Multi-jurisdictional
- Set-off or netting?
- Margin
- Regulatory (including capital) requirements

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Possible Structure: Clearing Master Set-off Agreement



(slide courtesy of Allen & Overy)

Options:

- ① Selective bilateral set-off
- ② Cross-affiliate set-off (pre-insolvency)

- ③ Cross-affiliate set-off (post insolvency)
(Note however Section 23A Federal Reserve Act)
- ④ Set-off of Customer reimbursement obligation if Customer owes

Other considerations:

- 1. Non derivative positions
- 2. Regulatory capital treatment
- 3. Collateral

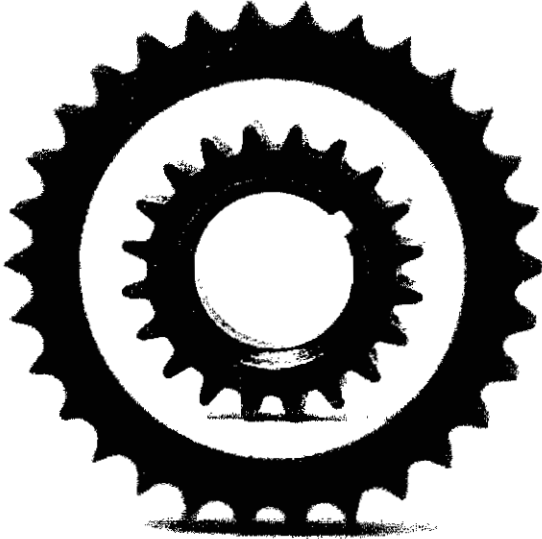
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- ⑤ Security interest over Customer's assets if FCM owes

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Process and Next Steps

- Currently in development in small ISDA WG based around Documentation Committee Advisory Board
- Will go to ISDA membership soon
- Legal opinions



*Section 2(a)(iii) of the ISDA
Master Agreement*

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Section 2(a)(iii) of ISDA 2002 Master Agreement

“Each obligation of each party under Section 2(a)(i) is subject to (1) the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing, (2) the condition precedent that no Early Termination Date in respect of the relevant Transaction has occurred or been effectively designated and (3) each other condition specified in this Agreement to be a condition precedent for the purpose of this Section 2(a)(iii).”

Overview

- Background
 - UK Treasury Consultation on investment bank resolution (December 2009)
 - US and UK litigation concerning Section 2(a)(iii)
 - Effect, purpose and history of Section 2(a)(iii) of the ISDA Master Agreement
 - Section 2(a)(iii) and close-out netting under Section 6(e)
 - Amendments to Section 2(a)(iii) in current ISDA documentation
 - Conditions precedent in ISDA Credit Support Documents
- Issues raised by Treasury consultation and recent cases
- Proposed amendments to Section 2(a)(iii) and related amendments to the ISDA Master Agreement
- Implementation issues

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Background

- UK Treasury consultation on investment bank resolution (Dec 2009)
 - driven by collapse of Lehman Brothers International (Europe)
 - call for market solution to “uncertainty” created by Section 2(a)(iii) as to whether and, if so, when insolvency estate will receive close-out amount
- Litigation concerning Section 2(a)(iii)
 - US
 - Metavante ruling by US Bankruptcy Court in *In re LBHI* (15 September 2009)
 - UK
 - *Marine Trade v Pioneer Freight Futures* (2009)
 - *Lomas v JFB Firth Rixson* (2010)
 - *LBSF v Carlton Communications* (2011)

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Section 2(a)(iii) in action

- Effect, purpose and history of Section 2(a)(iii)
 - obligations do not arise unless and until conditions precedent fulfilled
 - to protect a party from incurring additional exposure to a party defaulting or about to default
 - Section 2(a)(iii) in 1987, 1992 and 2002 versions of Master Agreement and comparable provisions in 1985 and 1986 ISDA Code of SWAPS
- Section 2(a)(iii) and close-out netting
 - Section 2(a)(iii) is not a “core provision” for close-out netting purposes
- Amendments to Section 2(a)(iii) in current ISDA documentation
 - *Sector-specific amendments*: Global Physical Coal Annex, US Emissions Allowance Transaction Annex, North American Power Annex
 - 10 or 15 business day limitation

ISDA Credit Support Documents

- 1994 New York law Credit Support Annex
 - Paragraph 4(a) (Conditions Precedent)
- 1995 English law Credit Support Deed
 - Paragraph 4(a) (Conditions Precedent)
- 1995 English law Credit Support Annex (title transfer)
 - constitutes a Transaction under ISDA Master Agreement
 - therefore relies on Section 2(a)(iii)

Issues raised by Treasury consultation and recent cases

- Time Limit Issue
 - should Section 2(a)(iii) be subject to a limited time period?
 - if so, what should that period be?
- Gross/Net Issue
 - is Non-defaulting Party owed gross or net obligations by the Defaulting Party while Section 2(a)(iii) applies?
- Duration of Non-defaulting Party's obligations
 - if the Non-defaulting Party relies on Section 2(a)(iii) and does not designate an ETD, when, if ever, do its obligations expire?

Proposed amendments

- Memorandum for Members (April 2011)
 - summarising relevant background, setting out the issues, proposing amendments
- Proposed amendments to Section 2(a)(iii)
- Comparable amendments to Para 4(a) of NY CSA and English CSD
- Proposed amendment to Section 9(c)
- 1992 Master: proposed amendment re interest accrual comparable to Section 9(h)(i)(3)(A) of 2002 Master
- Implementation
 - bilateral
 - Protocol (but preserving existing agreed amendments)

Questions?

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Equity Derivatives Initiatives

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2011 ISDA Equity Derivatives Definitions

- > ISDA has been reviewing the equity derivatives documentation to ensure that it continues to be:
 - > Effective in assisting the industry to meet its key objectives:
 - > Reducing confirmation backlogs
 - > Electronic matching and processing
 - > Trade transparency
 - > Up-to-date for market developments relating to the equity asset class
 - > Flexible enough to allow for new products to be efficiently documented
- > Commitment to supervisors to revise the 2002 Equity Derivatives Definitions to increase standardisation of legal terms
- > Target publication date of 31 May 2011

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Key Goals for 2011 Definitions

- > Expand the range of transactions contemplated by the definitions to cover:
 - > ISDA published Master Confirmation Agreement transactions
 - > Additional transactions and new provisions identified by working groups
- > Update the 2002 Equity Derivatives Definitions to review performance of key determinations in relation to recent market events

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A New Approach for the 2011 Definitions

- > A new approach and structure has been adopted for the 2011 Definitions
- > The 2011 Definitions are principles based, flexible and modular
- > The 2011 Definitions will comprise:
 - > a Main Book containing core definitions and the operative provisions
 - > will set out a menu of provisions
 - > can be combined to create different transactions
 - > an Appendix to the Main Book which contains:
 - > tables setting out possible elections/consequences
 - > fallbacks for certain elections if not specified in the Confirmation

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ISDA Transaction Matrices

- > ISDA will publish transaction specific matrices for certain transactions
- > An ISDA Transaction Matrix will set out the core terms of a particular transaction by completing a sufficient number of fields to allow that transaction to be documented using only the addition of a Transaction Supplement
- > ISDA Transaction Matrices will be agreed by the industry. This is a separate project and will be addressed by a separate future ISDA initiative
- > Transactions documented using ISDA Transaction Matrices will be readily supportable by electronic matching platforms

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New and Revised Substantive Features

- > Calculation Dispute Resolution Procedure
 - > Applies to Calculation Agent determinations (mathematical and non-mathematical)
 - > Can extend to Parties' determinations e.g. Determining Party
 - > Contemplates appointment of Independent Market Matters as Dispute Resolution Calculation Agents and Resolver
 - > Options for dealer poll or 'commercial reasonableness' only review
- > Change in Law
 - > Anticipating changes and Avoidance can apply
- > Transaction Illegality
 - > Has become or will be illegal to be a party

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New and Revised Substantive Features cont.

- > ~~Increased Performance Costs due to Change in Law~~
 - > Hedging Party has incurred or substantial likelihood that it will incur materially increased Performance Costs due to Change in Law
 - > Moved from Change in Law
- > Legal Uncertainty
 - > Can apply to Change in Law, Transaction Illegality and Increased Performance Costs due to Change in Law
 - > Public statement or action
 - > Reasonable likelihood of illegality
- > Inadvisability
 - > Can apply to Change in Law, Transaction Illegality and Increased Performance Costs due to Change in Law
 - > Public or private action or statement
 - > Reasonable likelihood of illegality/material adverse consequences

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New and Revised Substantive Features cont.

- > Decreased Performance Costs due to Change in Law
 - > Contemplates adjustment or payment if, after increased Performance Costs, Performance Costs decrease
- > Market Wide Hedging Disruption
 - > Triggered if affects Market Participants generally
 - > Not subject to Avoidance
- > Hedging Party Hedging Disruption
 - > Triggered if affects Hedging Party
 - > Subject to Avoidance
- > Increased Cost of Hedging/Increased Capital Charge Event
 - > Hedging Party incurs or substantial/reasonable likelihood that it will incur materially increased Hedging Costs or Capital Charges

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New and Revised Substantive Features cont.

- > Decreased Cost of Hedging/Decreased Capital Charge Event
 - > Hedging Costs or Capital Charges have materially decreased
- > Avoidance
 - > Hedging Party must take action that would satisfy all of the Avoidance Conditions to avoid terminating
 - > Parties can elect to apply to certain Additional Disruption Events
- > FX Disruption
 - > Inclusion of new ADE's related to FX/currency disruption

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New and Revised Substantive Features cont.

- > Governmental Intervention
 - > Seeks to address some of the fact patterns from governmental assistance during financial crisis e.g. AIG, Fortis, Fannie Mae/Freddie Mac
- > Cancellation Amount
 - > Replacement quotes sometimes not appropriate
 - > Ability to use quotes as to the value of the transaction
 - > Can take into account hedging losses/gains to differing degrees
 - > Different options to value at mid-market or from the perspective of a particular party

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Equity Derivatives Determination Committees

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Equity Derivatives Determinations Committees

- > What are they?
 - > Committees established in various Regions to determine whether or not a particular event constitutes a Market Disruption Event and whether a Disrupted Day has occurred
- > Which Regions?
 - > Japan, Asia ex-Japan, EMEA, Americas
- > Who will sit on the Committees?
 - > 10 largest sell-side participants based on global trading volumes (and other factors)
 - > 5 buy-side members with eligibility criteria similar to Credit Derivatives Determination Committee
 - > Consultative members (non-voting)

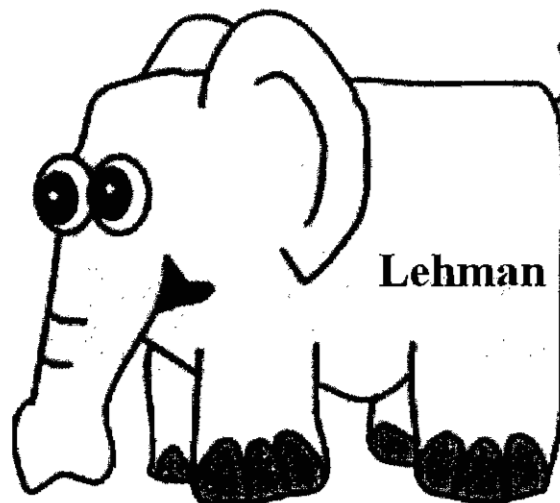
Update on Collateral Documentation Initiatives

Lauren Teigland-Hunt
Managing Partner
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Background



The Risk of “Over-Collateralization”

- Many buy side/non-dealer firms that posted “Independent Amounts” (or IA) to Lehman experienced material losses.
 - ◆ IA typically constitutes “excess collateral”
 - ◆ Excess collateral held by a failed counterparty = general unsecured creditor claim
- Possible means of reducing over-collateralization risk:
 - ◆ *Have a third party custodian hold IA/excess collateral*
 - ◆ Letters of Credit
 - ◆ Deduct IAs from unwinds/final payments
 - ◆ Reduce IAs to zero upon credit deterioration of holding party.

ISDA’s IA White Paper Initiative

- Drafting group launched in fall 2008
- Joint publication of ISDA, MFA and SIFMA’s Asset Management Group
- **Part I - The Use and Risks of Independent Amounts**
 - ◆ Published in October 2009
 - ◆ Addresses relevant market mechanics and risks associated with IA.
- **Part II - Alternate Approaches for Independent Amounts**
 - ◆ Published as part of final version of white paper in March 2010
 - ◆ Describes several alternative holding arrangements for IA and makes several recommendations

Alternate Holding Structures for IA

- **Unrestricted Direct Dealer Holding of IA**
- **Segregated Direct Dealer Holding of IA**
- **Segregated Dealer Affiliate Holding of IA**
- **Third Party Custodian of Dealer Holding of IA**
- **Tri-Party Collateral Agent Holding of IA**

Pros and Cons of Alternate Holding Structures

- Speed of Recovery
 - ◆ Dealer seizure of IA upon End User default
 - ◆ End User recovery of IA upon Dealer default
- Liquidity Benefit to Dealer
- Operational Cost

- 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...

Two Primary Objectives:

- Create standardized provisions for *triparty custodial/control agreements* that provide for the segregation of IA
- Create a *form of amendment for ISDA's Credit Support Annex* that provides for segregation of IA with a Custodian

US Dodd Frank Act Reinforces Need for Standardization

Proposed Section 724 provides:

- Swap dealers/MSPs must notify counterparties that they have *a right to require that any IA posted in respect of uncleared swaps be segregated at an independent custodian.*
- If a counterparty elects segregation for its IA, the account must be held at a custodian that is “independent” of both the counterparty and the swap dealer/MSP.
- Pursuant to a written tri-party custody agreement among the swap dealer/MSP, the IA pledgor and the custodian



Key Consideration in Triparty Control Agreements

- Secured Party’s need for perfection of its security interest
 - Paragraph 2 of CSA
- Pledgor’s desire for certainty of recovery if Secured Party defaults
 - Paragraph 8(b) of CSA
- Role of Securities Intermediary
 - No desire to police defaults, other matters relevant to a party’s entitlement to collateral

