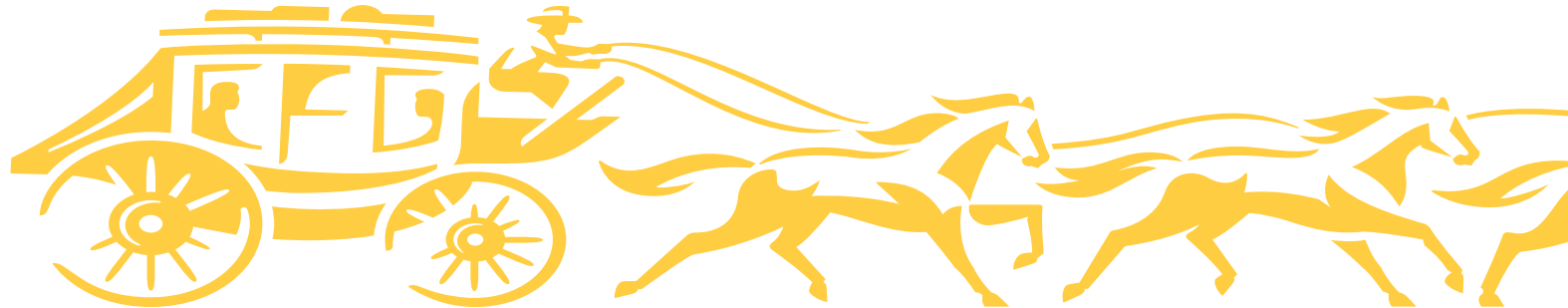


ISDA Credit Support Annexes & Related Documentation

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March 27, 2023



Collateral

- Collateral arrangements are a means to ensure that a party is protected against exposure in the event that their counterparty is unable to meet their financial obligations and defaults
- Collateral requirements arise from multiple considerations including credit exposure, a commercial relationship, and/or regulatory margin requirements
- Collateral obligations may be unilateral or bilateral

The Financial Crisis and Collateral Regulations

- Prior to the 2008 financial crisis, collateral was collected for commercial purposes
- New regulatory requirements enacted worldwide in response to the financial crisis, including Dodd Frank, now mandate collateral obligations for OTC (i.e., non-cleared) derivatives
- Initial Margin Requirements began in 2016 for dealers and will continue to be phased in through 2022

Regulatory Requirements under Dodd Frank

- U.S. regulations apply to swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants
- Regulations apply to non-cleared derivatives executed after the relevant compliance date or pre-existing trades that are amended after the relevant compliance date
- In addition to regulatory margin requirements, parties may negotiate more stringent terms depending upon the relationship between the parties and creditworthiness considerations

Documentation Arrangements

- Collateral arrangements typically cover all transactions governed by the ISDA Master Agreement between the parties and may take multiple forms (ISDA has published multiple forms for use with different jurisdictions and regulations)
- It is not unusual to have multiple CSAs between parties for different purposes including VM, IM and credit exposure (IA)
- Collateral can take different forms including cash, U.S. treasuries, agency securities, and equities
- Different forms of collateral are subject to varied haircuts
- The form of eligible collateral is prescribed by margin regulations for counterparties subject to such regulations

Legal Issues to Consider

- NY law CSA creates a security interest over collateral
- A security interest needs to be perfected in order to have priority over claims of competing creditors
- Perfection may be accomplished by varied means depending upon the jurisdiction and type of collateral
- A secured party may perfect by various forms of control or notification including possession, registration, notification to a custodian or governmental office, or book entry of securities with an account of a financial intermediary

Legal Issues to Consider (continued)

- Perfection for securities can further vary based upon whether the securities are debt or equity, bearer or registered, physical or book entry, or where they are held (directly at a custodian or indirectly through a clearing system such as DTC, Euroclear or Clearstream)
- Based upon the local law of the jurisdiction where your customer is domiciled, additional steps such as registration of a charge may be necessary to establish perfection or priority
- Local law considerations may also impact your ability to enforce your security interest and liquidate collateral upon a default, including potential notice to the pledgor, approval from the bankruptcy court, or public auction

Legal Issues: Suspect Periods and Conflicts

- In certain countries, insolvency laws include preference rules whereby a security interest in collateral delivered during a specified preference or “suspect period” prior to the insolvency of the pledgor may be invalidated
- Notwithstanding the selection of NY law as the governing law of the CSA between the parties, rights and obligations relating to the collateral may be impacted by the law governing the insolvency of the pledgor or the situs where the collateral is (or is deemed to be) located
- Conflicts of law rules may need to be considered, which can sometimes be a complicated analysis
- Book entry securities may be held through chains of intermediaries and the situs of the collateral may vary depending upon where the issuer is located, where the intermediary is located, or where the security is registered
- Under Article 8 of the NY UCC, if securities are held in an account at a securities intermediary in NY, then NY law governs perfection
- Similarly, if securities are held at Euroclear or Clearstream as intermediaries, then Belgium and Luxembourg will be the respective locations of securities held through them as intermediary

IM and VM Obligations

- Unless a counterparty can avail itself of the end-user exception or is a financial end-user without material swaps exposure, an uncleared swap is subject to regulatory margin requirements
- U.S. margin requirements were designed to promote central clearing and reduce systemic risk to the financial system
- Counterparties may be subject to international margin regulations as well
- U.S. regulations distinguish between Initial Margin (IM) and Variation Margin (VM)

IM and VM Obligations (continued)

- IM is intended to secure the potential change in value of derivatives entered into with a counterparty after that counterparty goes into default but prior to replacement of such derivatives
- IM is referred to as Independent Amount in the 94 CSA, Margin Amount (IM) in the 2016 New York IM CSA, and Margin Amount (IM) or Margin Amount (IA) in the 2018 IM New York CSA
- VM is intended to secure against ongoing changes in the mark to market value of derivatives entered into between the parties

IM and VM CSA Architecture

- ISDA published new credit support documentation in 2016 in response to new margin regulations
- The new architecture split IM and VM into separate CSAs in order to:
 - permit market participants that were not immediately (and may never be) subject to IM obligations to avoid the complications associated with posting and collecting IM
 - accommodate a regulatory only 2016 ISDA VM Protocol
 - avoid an overly complex single CSA covering both IM and VM

IM and VM CSA Architecture (continued)

- In anticipation of Phases 4, 5 and 6 of margin regulations, ISDA published the 2018 IM New York law CSA (as well as other IM collateral arrangements)
- 2018 IM New York law CSA contemplates that dealers may require their non-dealer counterparties to post IA (negotiated non-regulatory initial margin) in addition to IM required by the margin rules
- Both parties must post VM (in addition to IM)
- IM must be collected and posted by both parties if the IM Exposure of each party and its affiliates exceeds certain threshold exposure
- IM is calculated using a model approved by regulators or a table in the regulation
- ISDA developed ISDA SIMM for use by market participants

Segregation

- Margin regulations mandate segregation of IM at an independent third-party custodian pursuant to an account control agreement rather than having the pledgor post the IM obligation directly to the secured party
- Due to the requirement to segregate IM at a third-party custodian and an explicit prohibition under the margin rules, there is no ability to rehypothecate IM
- IM posting obligations between the parties to an ISDA may not be netted against each other
- In addition, with respect to IA, CFTC Rules obligate swap dealers to notify counterparties of their right to segregate IA at a third-party custodian in advance of the first transaction giving rise to an IA posting obligation
- While IA may be netted against VM, IM cannot

2020 Updates to Margin Rules

- Applicable specifically to IM rules, the Prudential Regulators updated the rule, effective August 31, 2020
- Impactful updates:
 - Affiliates of covered swap entities are no longer required to post regulatory initial margin, with certain qualifications
 - Clarified that swaps amended solely to accommodate a Benchmark cessation event (e.g., LIBOR) will not trigger margin requirements
 - Split Phase 5 into two phases (Phase 5 and Phase 6): Phase 5 included counterparties above \$50b AANA and Phase 6 included counterparties above \$8b AANA
 - Clarified certain other non-material amendments can be made to swaps without triggering margin requirements
- The regulators also pushed the compliance dates for Phase 5 and 6 back one full year each to September 1, 2021 and September 1, 2022 respectively

Key Terms of ISDA CSAs

1994 New York CSA: Key Terms

- The 1994 New York law CSA was published by ISDA in 1994 and supplements and forms part of the Schedule to the 1992 ISDA Master Agreement (and may be modified for use with the 2002 ISDA) and is a credit support document under such ISDA Master
- The 1994 CSA is designed for use where the grant of a security interest, and related matters of priority and perfection, will be governed by New York law
- The 1994 CSA is a bilateral agreement that contemplates both parties making transfers of collateral
- In addition to cash or readily marketable securities, it is possible to include additional forms of credit support (e.g., letters of credit) to be transferred
- 1994 CSA is comprised of the pre-printed form (paragraphs 1-12) and a paragraph 13 where parties select elections and variables

1994 New York CSA: Key Terms (continued)

- Paragraph 1: Interpretation – specifies inconsistency hierarchy and that the agreement is bilateral
- Paragraph 2: Security Interest – provision covering the grant and release of the security interest and lien over the collateral
- Paragraph 3: Credit Support Obligations – sets forth calculation of Delivery Amount, Return Amount, and Credit Support Amount
- Paragraph 4: Conditions Precedent, Transfer Timing, Calculations and Substitutions – sets forth the conditions and mechanics relating to transfer obligations, valuation and exposure calculation mechanics, and the process and timing for collateral substitution

1994 New York CSA: Key Terms (continued)

- Paragraph 5: Dispute Resolution – sets forth the terms applicable to valuation disputes and requires delivery of the undisputed amount while resolution is pending
- Paragraph 6: Holding and Using Posted Collateral – imposes a standard of care and specifies the conditions that must be satisfied in order for a party or its custodian to hold collateral; sets forth the right of use over the collateral
- Paragraph 7: Events of Default – specifies defaults related to collateral (e.g., failure to transfer) and related grace periods
- Paragraph 8: Certain Rights and Remedies – sets forth the rights and remedies of both secured party and pledgor in respect of collateral in the event of both default and non-default scenarios

1994 New York CSA: Key Terms (continued)

- Paragraph 9: Representations – sets forth representations related to the security interest in the collateral
- Paragraph 10: Expenses – allocation of costs, including upon liquidation following a default
- Paragraph 11: Miscellaneous – includes miscellaneous provisions related to Default Interest, provision of Further Assurances and Further Protection, duty to act in Good Faith and Commercially Reasonable Manner, Demands and Notices, and Specifications of Certain Matters that may be made in Paragraph 13 or other documents (e.g., confirmations)
- Paragraph 12: Definitions – defines terms used in the Annex
- Paragraph 13: Elections and Variables – parties make elections and modifications to the Annex

IM CSAs: Key Terms

- 2016 IM New York CSA: based on the 1994 New York CSA and intended for use by the phase one dealers to comply with IM requirements imposed on phase one dealers in 2016, which continued to be used by phase two and three entities
- 2018 IM New York CSA: updated form published by ISDA focused on the broader range of entities coming into scope in phases 4, 5, and 6, including buy-side firms
- Key Requirements include: calculation of IM either by an approved model (such as ISDA SIMM) or a regulatory prescribed table (aka grid), IM exchanges are two way and collateral posted in opposite directions may not be netted, segregation of IM, and “Covered Transactions” (in-scope trades) are subject to IM
- For both the 2016 IM New York CSA and the 2018 IM New York CSA, there may be situations where each party pledges under a separate one way IM CSA (and the governing law of each may differ)
- If there is no well-founded basis to reach a positive netting determination, then IM and VM must be calculated on a gross basis

IM CSAs: Key Terms (continued)

- Margin Approaches: Under the 2018 IM CSA, the parties may elect one of three approaches to determine how IA is treated in conjunction with regulatory required IM (Distinct Margin Flow, Allocated Margin Flow, or Greater of Margin Flow)
 - Distinct Margin Flow Approach: for a posting leg, there are two distinct flows (one for regulatory IM and another for non-regulatory IA) and the flow for IM has no impact on the flow for IA (the two flows are posted under different credit support documentation)
 - Allocated Margin Flow Approach: for a posting leg, there are two distinct flows (one for regulatory IM and another for non-regulatory IA) but the amount of IA is reduced by the amount of IM required to be transferred (note that, like with the Distinct Margin Flow Approach, here the IA can be rehypothecated because it is not posted under the IM CSA)
 - Greater of Margin Flow Approach: for a posting leg, there is one combined flow for IM and IA that is the greater of IM and IA (here the IA is posted under the 2018 IM New York CSA so there is no ability to rehypothecate IA)

IM CSAs: Key Terms (continued)

- General Principles: sets forth general principles relating to one or more applicable margin regimes (“Regimes”) and addresses regulatory posting and collection obligations, including that, if multiple Regimes apply, the amount of IM collected and posted must satisfy the strictest requirements under the applicable Regimes (“Strictest Of”)
- Regime Tables: each party specifies the Regimes under which it has an obligation to post or collect initial margin and also makes elections for determining what method will apply to each Regime (e.g., ISDA SIMM versus grid)
- Covered Transactions: defines what types of trades are in-scope for particular Regimes

IM CSAs: Key Terms (continued)

- Secured Party Rights Event, NEC (notice of exclusive control) Event, and Pledgor Rights Event: collateral access provisions that address applicable regulatory requirements for timely access to collateral
- Eligible Collateral Schedule: to be used where parties are specifying eligible collateral and applicable haircuts outside of a relevant control agreement (this can be found outside the IM CSA in the Account Control Agreement as well)

IM CSAs: Key Terms (continued)

- Choice of Custodians: parties need to consider what risk allocations are appropriate with respect to a custodian failure
 - Custodian (IM Risk): the parties need to assess allocation of responsibility for a failure to comply or other default by a third-party custodian
 - The phase one form allocated liability for custodian acts or omissions to the pledgor and secured party's transfer obligations were satisfied with the giving of appropriate instructions
 - 2018 IM New York CSA allows parties to elect to replace the Custodian (IM) Risk provision set forth in Paragraph 6(a) by election in Paragraph 13
 - Custodian Event: if applied, custodian acts or omissions will not constitute an Event of Default and instead provides the pledgor with an opportunity to cure and replace the custodian before a specified date, with a failure to replace by the specified date constituting an Additional Termination Event (all Covered Transactions are Affected Transactions and both parties are Affected Parties)

Other Documentation

- 2016 VM New York CSA: based upon the 1994 New York CSA (with revisions to establish a security interest based arrangement that meets regulatory VM requirements for uncleared swaps) but, unlike the 1994 CSA, which can cover both variation margin and independent amounts (initial margin not required by regulation), the 2016 VM CSA only covers VM (the VM CSA can be amended from its standard form to incorporate an independent amount)
- ISDA Clearstream and Euroclear Collateral Transfer Agreements
- Euroclear and Clearstream Security Agreements
- 2019 Multi-Regime CTA and Security Agreements
- English Law IM Credit Support Deeds
- Custodial documentation: bespoke custodian specific bilateral custody agreement and triparty control agreement
 - Pledgor Access Provisions can be controversial in negotiations

Live Content Slide

When playing as a slideshow, this slide will display live content

Poll: 2. What is the most common commercial reason for setting up an ISDA Master Agreement for your firm or clients?