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DERIVATIVES

Best Practices for Fund Managers When Entering Into ISDAs: Negotiating Collateral Arrangements (Part Three of Three)

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When the Dodd-Frank Act introduced central clearing for certain standardized, liquid swaps, one of its primary goals was to reduce the amount of credit risk between counterparties to derivatives that historically traded in the over-the-counter (OTC) market. For cleared swaps, a regulated clearinghouse is interposed between the two original parties to the transaction. The clearinghouse becomes a counterparty to each of the original parties, which post margin directly with the clearinghouse. Consequently, once the trade is cleared, the parties no longer have exposure to each other. If one party defaults on the trade, the clearinghouse is contractually obligated to pay all amounts owed to the non-defaulting party.

The clearing model is in stark contrast to the bilateral trading model that applies to uncleared swaps, where one party delivers collateral directly to the other party. To mitigate counterparty credit risk, parties enter into a credit support annex (CSA),[1] which sets forth the collateral arrangements between the parties, such as whether a party is required to deliver collateral to the other party and the type of collateral permitted. See "Celent Report Identifies Best Practices for Over-the-Counter Derivatives Collateral Management" (Jul. 29, 2009).

In this final installment in our three-part series, we discuss the key considerations for funds when negotiating the CSA. The first article provided background on the various agreements that govern swaps and explained the impact the Dodd-Frank Act has had on trading these instruments. The second article reviewed the most highly negotiated events of default and termination events in swap trading agreements and offered suggestions for negotiating these provisions.

An Introduction to the CSA

Parties may choose from various forms of the CSA issued by the International Swaps and Derivatives Association (ISDA), depending upon whether they seek to have their collateral arrangements governed by New York, English or Japanese law. Unless the context suggests otherwise, we have assumed for purposes of this article that the parties are negotiating the 1994 version of the CSA governed by New York law, and capitalized terms within quotation marks shall have the meaning specified in that agreement. It should be noted that in 2016, ISDA issued revised versions of the CSA to consider the new variation margin requirements for non-cleared swaps, which will also be highlighted herein.

Paragraphs 1 through 12 of the CSA are standardized, and any modifications to these provisions are documented in Paragraph 13. As drafted, the CSA is bilateral in nature, meaning that it contemplates that both parties may post and receive collateral as security for a derivative transaction subject to the 1992 or 2002 ISDA Master Agreement (Master Agreement).[2]

Collateralization and the Negotiation of the CSA

Variation (Mark-to-Market) Margin

The primary way that parties historically managed their counterparty credit exposure was for one party (Pledgor) to deliver collateral to the other party (Secured Party) to the extent that the Secured Party had a net exposure[3] across all its open OTC derivative transactions under the Master Agreement.

Note that neither of the terms "variation margin" nor "mark-to-market margin" are used in the 1994 versions of the CSA. They have become common industry terms, however, and refer to the delivery of collateral to protect counterparties from fluctuations in the market value of their OTC derivative transactions. See "Hedge Fund Sues Wachovia and Citibank Alleging the Banks Demanded Excessive Collateral in Connection With Credit Default Swaps Based on Collateralized Debt Obligations" (Mar. 11, 2008).

One-Way CSAs and Asymmetrical Thresholds

While the CSA contemplates a two-way exchange of collateral, in the past, dealers often insisted that the CSAs be one-way in nature, meaning that only the dealers' counterparties (*e.g.*, hedge funds) were required to deliver collateral, explained Purrington Moody partner Tess Weil. One-way CSAs can be accomplished in a few ways.

First, in Paragraph 13, the dealer can limit the definition of Secured Party to the dealer, so only the dealer will be entitled to receive collateral for its mark-to-market exposure. Another option is to set asymmetrical "Thresholds" in Paragraph 13 of the CSA. To the extent that a Pledgor successfully negotiates a Threshold greater than zero, this will decrease the amount of collateral it must post to the Secured Party. A Threshold set at the value of infinity will result in that party never having to post collateral to the other party; thus, the CSA becomes one-way in nature.

Historically, certain dealers insisted that they receive the benefit of high Thresholds, while their counterparties often had Thresholds equal to zero. Today, one-way CSAs and Thresholds only in favor of the dealer are less common, explained Weil.

In terms of hedge funds negotiating their own Thresholds, Fabien Carruzzo, a partner at Kramer Levin Naftalis & Frankel, noted that some large funds that carry a significant amount of leverage with a dealer may successfully have been able to negotiate their own Thresholds. However, with the advent of regulated variation margin and the prohibition against Thresholds, one-way CSAs and Thresholds will soon become a thing of the past.

Independent Amounts

Another tool that parties (and particularly dealers) use to minimize counterparty risk is the requirement that the counterparty post an "Independent Amount," the technical term for what is commonly referred to as initial margin. The Independent Amount, which may be calculated at the portfolio level or on an individual transaction basis, provides an additional buffer for the party receiving the collateral in the event of a default by the counterparty. The posting of an Independent Amount is in addition to the posting of variation margin and typically results in the over-collateralization of the party receiving the collateral.

A confirmation will specify an Independent Amount that is negotiated at the time of a transaction (Confirmation). Some dealers require a fallback provision in the CSA, stating that if an Independent Amount is not otherwise set forth in the Confirmation, then the Independent Amount shall equal a specified percentage of the notional value of the trade. The fallback Independent Amount, warned Carruzzo, is typically significantly higher than what a portfolio manager for the fund would negotiate, making it important for the investment professional to negotiate Independent Amounts at the time of execution.

Segregation of Independent Amounts

One concern that came to light with the bankruptcy of Lehman Brothers was the difficulty a party would have recovering Independent Amounts from an insolvent counterparty that had rehypothecated Independent Amounts or commingled Independent Amounts with their own assets. This led to an industry-wide discussion[4] about whether Independent Amounts posted by private funds should be segregated from the dealer's assets and held with an independent third-party custodian.

Unlike in the prime brokerage context, applicable law does not limit a dealer's right to rehypothecate these assets, although a limit could be negotiated between the parties. See "How Fund Managers Can Mitigate Prime Broker Risk: Preliminary Considerations When Selecting Firms and Brokerage Arrangements (Part One of Three)" (Dec. 1, 2016). The CFTC weighed in with the adoption of the Collateral Segregation Rule, guaranteeing counterparties such as private funds the right to elect (while not requiring) that Independent Amounts be segregated with an independent third party custodian.

Costs of Segregating Independent Amounts

One of the best ways to protect a fund's assets in the event of a dealer's insolvency is to have the fund's Independent Amounts held with an independent third-party custodian and to negotiate robust collateral access rights, explained Carruzzo. There is a cost in doing so, however, including the establishment of a new custody account; negotiation of additional custody and collateral control arrangements; and payment of initial set-up and ongoing custodial fees. Because of the additional costs associated with this practice, private funds typically only pursue this option if they have sufficient exposure to the dealer to justify the cost.

Conditions Precedent to Performance

Like the Master Agreement, Paragraph 4(a) of the CSA includes conditions precedent to performance, one of which provides that a party may cease delivering and returning collateral to a counterparty that has experienced an "event of default, potential event of default or specified condition." Unlike the condition precedent in the Master Agreement and subject to negotiation by the parties, however, the condition precedent in the CSA contemplates permitting a party to cease performing upon the occurrence of a termination event or an additional termination event (ATE), as the term specified condition refers to both.[5]

Fund counterparties should seek to negotiate a sunset provision on this condition precedent such that after a certain amount of time, the non-defaulting party must either resume making margin payments (or returning margin) under the CSA or move to early terminate the transactions, suggested Robin Powers, a partner at Rimon Law.

New Mandatory Margin Rules

In 2015, as required by the Dodd-Frank Act, the CFTC and other regulators promulgated rules imposing minimum margin requirements (Mandatory Margin Rules) on swap dealers, major swap participants and certain other regulated institutions with respect to their trading of certain uncleared swaps.

With respect to initial margin, the Mandatory Margin Rules require covered swap dealers trading swaps with funds that have "material swaps exposure" to collect and post initial margin on a daily basis. A fund will be deemed to have material swaps exposure if it and its affiliates have an average daily aggregate notional amount calculated in accordance with the Mandatory Margin Rules that exceeds $8 billion.

While most funds are accustomed to posting initial margin, this will be a sea change for dealers who historically have not had to post Independent Amounts, explained Warshaw Burstein partner Marilyn Selby Okoshi. Compliance with the new initial margin rules began September 1, 2016, and is being phased in over a four-year period.

The Mandatory Margin Rules also require covered swap dealers to collect and post variation margin with all financial end-users, which include private funds. Mark-to-market margining is required regardless of whether the fund has material swaps exposure. The Mandatory Margin Rules as they apply to variation margin are codifying what the original CSA was intended to do, noted Okoshi. "From an operational perspective, the new rules may not alter the relationship for funds that have bilateral CSAs with their counterparties with zero dollar Thresholds and 'Minimum Transfer Amounts' (MTAs)[6] below $500,000," she explained, "although their documentation will need to be updated."

The deadline for compliance with the new variation margin requirements is March 1, 2017, at which point affected market participants will need to amend or adopt new documentation to comply with the new rules.

See our two-part series on the impact of the final swap rules on hedge funds: "Increased Margin Requirements" (Feb. 18, 2016); and "Increased Trading Costs" (Feb. 25, 2016).

Variation Margin Protocol

In 2016, ISDA released the 2016 Variation Margin Protocol, which is intended to assist parties with compliance with the Mandatory Margin Rules. Protocols were first introduced by ISDA in 1998 as a way for market participants to implement industry standard changes to their documentation. See "Katten Partner Raymond Mouhadeb Discusses the Purpose, Applicability and Implications of the August 2012 ISDA Dodd-Frank Protocol for Hedge Fund Managers, Focusing on Whether Hedge Funds Should Adhere to the Protocol" (Jan. 24, 2013).

One of the primary benefits of adhering to protocols is the elimination of the time and cost associated with bilateral negotiations between dealers and the end-users. Private funds need to understand, however, that when they adhere to a protocol, they are supplementing their existing documents; therefore, managers should ensure they understand the provisions included in the protocol and arrange for easy retrieval of protocol documents. See "Five Steps for Proactively Managing OTC Derivatives Documentation Risk" (Apr. 25, 2014).

It is expected that many market participants will rely upon the 2016 Variation Margin Protocol to ensure compliance with the Mandatory Margin Rules. Carruzzo warned that completing the protocol is slightly more complicated than adhering to some of the earlier protocols, however. Consequently, funds should begin the adherence process sooner rather than later, to ensure their trading of uncleared swaps continues without interruption. As an alternative, funds may elect to enter into an amendment to their CSAs with their dealer counterparties.

The Role of the Valuation Agent

The "Valuation Agent" determines the amount of a party's exposure and related margin payments, as well as the value of any collateral to be posted. The CSA, in many cases, contemplates the role of Valuation Agent as a shifting one, where the party that is owed margin is the Valuation Agent for that collateral call.

This can result in a deadlock, however, where both parties take the view that they are owed margin, noted Carruzzo. For this reason, some dealers insist upon always being the Valuation Agent, unless the dealer has experienced an event of default, in which case dealers are typically willing to cede this role to the fund or to an independent third-party valuation agent.

Unlike the Master Agreement, the CSA contains a hard-wired dispute mechanism. In most cases, the parties agree to the dispute mechanics as set forth in the CSA. However, fund counterparties should understand, explained Carruzzo, that if the dealer is the Valuation Agent at all times, for illiquid trades where the dealer is unable to obtain a valuation quote from an independent dealer, the dealer's original valuation will prevail in the event of a dispute.

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[1] A copy of the CSA is available for download for a fee from the ISDA website.

[2] A copy of the 1992 and 2002 Master Agreements are available for download for a fee from the ISDA website.

[3] The technical definition of exposure is included in Paragraph 12 of the CSA; however, it generally means the netted mid-market mark-to-market value of the transactions that would be payable to the Secured Party by the Pledgor if all transactions were terminated as of the valuation date.

[4] See a 2010 white paper published by ISDA discussing steps that end-users can take to mitigate or eliminate losses of Independent Amounts in the event a dealer becomes insolvent.

[5] Specified conditions are elected in Paragraph 13 and include termination events, including any ATEs. To the extent that ATEs are included as a specified condition, the guidance note in the CSA indicates that only ATEs that are otherwise designated in the schedule to the Master Agreement should be included.

[6] An MTA sets a threshold below which collateral will not be transferred between the parties. The parties may specify an MTA at any level in Paragraph 13 of the CSA, and different amounts may

apply to each party. The purpose of an MTA is to eliminate the need to move collateral of a de minimis amount that does not otherwise pose a material credit risk.
