

ALERTS

ISDA Publishes Tri-party IA Notices for the Custody of Collateral for OTC Swap Counterparties

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The International Swaps and Derivatives Association (ISDA) recently published Tri-party IA Notices as part of its ongoing roll-out of documentation developed in response to the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Tri-party IA Notices are supplemental documentation designed to expedite the negotiation of control-agreement documents for establishing third party custodian relationships for over-the-counter derivatives contracts and swap arrangements.

Swap counterparties that are neither swap dealers nor major swap participants (generally, the “buy-side”) may elect to custody posted Independent Amounts with a third party custodian, instead of with their swap dealer counterparties. In the event the swap dealer counterparty were to become a debtor under the Bankruptcy Code, the other party would be an unsecured creditor with respect to any collateral that it may have posted to the swap dealer counterparty under the ISDA Master Agreement and related Credit Support Annex.^[1] Using a third party custodian to hold any collateral posted with a swap dealer may allow a buy-side counterparty to obtain the return of its collateral upon the designation of an Early Termination Event or after the occurrence of a Termination Event or Event of Default, including a Bankruptcy Event of Default. Other insolvency proceeding regimes have similar concepts.

The buy-side has experienced increased costs and delays as they attempt to negotiate the documentation necessary to set-up a third party

custodian relationship. The agreements generally include an account control agreement, a fee letter, a sample notice of exclusive control and a termination notice. In an attempt to expedite the negotiation of these agreements, ISDA published the Tri-party IA Notices which are the Notice of Exclusive Control, Pledgor Access Notice (usually referred to as the Notice of Termination) and the Conflicting Instructions Provision. The ISDA Tri-party IA Notices do not provide a template account control agreement; ISDA only provides the supplement documentation which will reference the account control agreement which will be supplied by the third party custodian.

The Notice of Exclusive Control and Pledgor Access Notice are very similar, except that the Secured Party (the swap dealer) sends the Notice of Exclusive Control to the third party custodian (the "Securities Intermediary") following an Event of Default or Specified Condition where the buy-side counterparty is the Defaulting or Affected Party, and the Pledgor (the buy-side party to the swap) sends the Pledgor Access Notice to the Securities Intermediary following an Event of Default or Specified Condition where the Secured Party is the Defaulting or Affected Party. Also, each letter contains two versions identified as Version A and B. Version A permits the party sending the notice to withdraw all of the collateral in the account whereas Version B requires that the party sending the letter identify the Independent Amount which is required to remain in the account and the Independent Amount which is excess collateral. For example, if the Pledgor is sending Version B of the Pledgor Access Notice, it would only be entitled to withdraw the Excess Independent Amount and the Required Independent Amount would remain in the account for the benefit of the Secured Party even if the Secured Party is the Defaulting or Affected Party under the ISDA Master Agreement.

The ISDA Tri-party IA Notices do not address two of the key points that are generally addressed during negotiations. Some swap dealers may want the right to dispute the occurrence of an Event of Default or Specified Condition, although each of these terms has a relevant cure or notice requirement in the ISDA Master Agreement. Separately, swap dealer counterparties may want to incorporate a waiting period or delayed release time between the time the Notice of Exclusive Control or Pledgor Access Notice is delivered to the Securities Intermediary and is declared an effective notice by the Securities Intermediary and the time when the Securities Intermediary releases the collateral to the Secured

Party or Pledgor (as the case may be). Proposed waiting periods or delayed release times are generally 2 business days.

The five major elections to be made in the Notice of Exclusive Control and Pledgor Access Notice are:

1. A swap counterparty selects whether it may obtain the collateral because of the occurrence of a Specified Condition and/or Event of Default, or it may refer to specific events as they appear in the Schedule or pre-printed form of the ISDA Master Agreement;
2. A swap counterparty selects whether the mere occurrence of an Event of Default or Specified Condition will give rise to the right to obtain the collateral, or whether the right commences after an Early Termination Date has either occurred or been designated as a result of the occurrence of an Event of Default or Specified Condition;
3. The swap counterparty must provide information on where the collateral should be transferred to it;
4. The parties may identify whether the Event of Default or Specified Condition is an “indisputable event,” which in most cases refers to a Bankruptcy Event. When a party identifies a particular event as an “indisputable event” in the Notice of Exclusive Control or Pledgor Access Notice, it is representing to the Securities Intermediary that dispute resolution procedures, delivery delays or similar conditions will not apply to the release of collateral. If the “indisputable event” is defined as a “Bankruptcy Filing Evidence Event,” the parties are required to provide at least one piece of evidence of the “indisputable event,” but providing evidence is not a condition for the Securities Intermediary releasing the collateral; and
5. The parties may choose to require that the Securities Intermediary forward a copy of each notice to the other party.

The third document included in the ISDA Tri-party IA Notices is the Conflicting Instructions Provision, which will supplement the account control agreement. This document determines what the Securities Intermediary should do if it receives a Notice of Exclusive Control as well as a Pledgor Access Notice. The options are: (i) the first document delivered to the Securities Intermediary wins (subject to Securities Intermediary’s ability to declare when each became effective and subject to any dispute resolution provisions), (ii) the Notice of Exclusive Control

prevails or (iii) the Securities Intermediary may elect to refrain from releasing the collateral until it obtains a legal opinion, joint written instruction from the Secured Party and Pledgor or final court order.

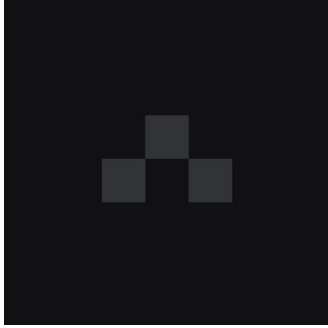
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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

[1] Upon a bankruptcy of an entity, the “automatic stay” generally would preclude creditors from exercising remedies against the debtor during its bankruptcy case. The Bankruptcy Code contains “safe harbor” provisions, however, aimed at protecting parties’ rights and remedies under a swap agreement, notwithstanding the automatic stay. These provisions permit a party to a swap agreement to terminate, liquidate and accelerate the swap agreement upon its counterparty’s bankruptcy, and setoff any net loss against collateral posted in connection with the swap agreement, all without the need for court approval. The Bankruptcy Code’s safe harbor provisions are inapplicable to a return of excess collateral posted for the debtor’s benefit. Thus, upon the bankruptcy of the swap dealer counterparty, if the collateral were posted directly with such entity, the automatic stay would preclude the other party from taking actions to collect its excess collateral, and the other party would be left with a general unsecured claim for return of its collateral.

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