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ISDA Close-Out Amount Protocol

The International Swaps and Derivatives Association, Inc. (ISDA), published the ISDA Close-Out Amount Protocol ("Protocol") today. The Protocol is intended to allow market participants to amend the terms of existing 1992 ISDA Master Agreements (including 1992 ISDA Master Agreements deemed to have been entered into by virtue of long-form confirmations, "Covered Master Agreements") by replacing Market Quotation or Loss as the close-out payment measure with the Close-out Amount provisions of the 2002 ISDA Master Agreement.¹

Many end-users prefer Market Quotation as the close-out methodology under the 1992 ISDA Master Agreement because it offers the prospect that any close-out payment will be determined objectively based upon market quotations obtained from third parties. While the process contemplated by the Protocol may better reflect the difficulties of valuing terminated derivative transactions in the event of the close-out of a "major" market participant or in a particularly volatile market, Market Quotation may continue to be a reasonable election for the majority of close-outs and for end-users that enter into only a few vanilla derivatives transactions. Below, we discuss key provisions of the Protocol that should be reviewed in connection with assessing whether adherence is appropriate for any particular end-user.

Background

The Close-out Amount mechanism² was designed after the 1997-1998 financial crisis in an effort both to loosen the strict methodology of Market Quotation and to provide some discipline to the freedom of the Loss method. The new Close-out Amount methodology is incorporated into the 2002 ISDA Master Agreement; however, its effect has been limited by the hesitance of some parties to use the 2002 ISDA Master Agreement. Many end-users, and even some derivatives dealers, are more comfortable with the 1992 ISDA Master Agreement and have been slow to migrate to the 2002 ISDA Master Agreement.

The Protocol is a result of ISDA's efforts to accelerate the migration to Close-out Amount motivated by a commitment the dealers made in the recent Counterparty Risk Management Policy Group III report (a copy of which is available [here](#)),³ as well as a response to the chaos that ensued following the bankruptcy of Lehman Brothers. In the aftermath of Lehman's insolvency, many market participants were not able to obtain Market Quotations to value their terminated transactions, but were nonetheless required to follow the procedures laid out under 1992 ISDA Master Agreement for seeking such quotations before reverting

¹ Under the 1992 ISDA Master Agreement, the parties elect whether early termination settlement payments are to be determined based upon dealer quotes (Market Quotation method) or a more general "damages" provision under which the determining party calculates its gain or loss on the terminated transactions (Loss method).

² Close-out Amount is the amount of losses or costs, or gains (as the case may be) under then-prevailing circumstances in replacing or providing for the economic equivalent of the material terms of the terminated transactions and any option rights. In determining the Close-out Amount, the Determining Party (i.e., the party determining the Close-out Amount, which is generally the non-defaulting party) is charged with acting in good faith and using commercially reasonable procedures to produce a commercially reasonable result.

³ The Counterparty Risk Management Policy Group III report is entitled "*Containing Systemic Risk: The Road to Reform*" (Aug. 6, 2008). This is the latest in a series published by the policy group, which includes senior management from major financial institutions. The report, published in response to the credit crisis, recommends a number of initiatives to be undertaken by private institutions to complement official oversight and help contain systemic risk.

to Loss. Many participants undertook this exercise with trepidation that a court or a bankruptcy trustee may, with the benefit of hindsight, review the reasonableness of any decisions to revert to the Loss method.

Close-out Amount arguably addresses certain problems highlighted in the Lehman bankruptcy with respect to obtaining Market Quotations or applying Loss by providing a general requirement that a party act in good faith and use commercially reasonable procedures to reach a commercially reasonable result. This process favors using neutral third-party sources of value, such as market prices, but allows for flexibility in methodology, to the extent that rigidity of methodology would sacrifice reasonableness in the process.

The Protocol

Parties to a Covered Master Agreement may adhere to the Protocol and be bound by its terms by completing and delivering an Adherence Letter to ISDA at COAprotocol@isda.org. A copy of the Adherence Letter is available [here](#).

By adhering to the Protocol, the “Adhering Party” agrees that the terms of each Covered Master Agreement between it and another Adhering Party will be amended with effect from the date that ISDA receives the Adherence Letter from the later of the Adhering Parties to that agreement.

A party may specify in the Adherence Letter whether the amendments to the ISDA Definition Booklets provided by Annexes 1 through 9 of the Protocol will be applicable. For Annexes 1 through 9 to be applicable, both parties to a Covered Master Agreement have to select the “applicable” option. A copy of Annexes 1 through 9 is available [here](#).

A party may also choose to keep Loss as the applicable payment measure, whether Loss applies as the close-out payment measure to all or only a portion of transactions under a Covered Master Agreement, by selecting “Loss Preserved Election” in the Adherence Letter. If one party has made the Loss Preserved Election, the Protocol will not apply to those transactions covered by Loss in the relevant Covered Master Agreement, but will apply to all other transactions under that agreement.

Except for the above mentioned choices, an Adhering Party may not specify additional provisions, conditions or limitations in its Adherence Letter.

Adherence to the Protocol is irrevocable, except that an Adhering Party may revoke its adherence during the Annual Revocation Period designated by ISDA, by delivery of a Revocation Notice to ISDA. A copy of the Revocation Letter is available [here](#). Revocation of adherence will apply only to Covered Master Agreements entered into *after* the revocation.

Any amendment, modification or waiver in respect of matters covered by the Protocol will be effective only between the parties who agree to make such amendment, modification or waiver by expressly referring to paragraph 4(c) of the Protocol.

Comments

While the Protocol may appear to be an easy solution to problems surrounding the Lehman terminations, there are some key issues that parties should consider when deciding whether or not to adhere to the Protocol.

- Parties will need to perform due diligence on all of their existing 1992 ISDA Master Agreements *before* adhering to the Protocol. If both parties to a Covered Master Agreement adhere to the

Protocol, the Close-out Amount provisions will supersede any specific modifications that the parties may have made to the replaced provisions, such as specific carve-outs for FX or commodity transactions, unless one of the parties to the Covered Master Agreement specifically elects to allow a prior Loss election to be preserved with respect to termination of certain transactions under the agreement (the Protocol does not override a specific methodology that is incorporated into a transaction confirmation with respect to termination of that transaction only).

- Each Adhering Party will also be required to represent that adherence will not adversely affect any obligations owed under any Credit Support Document in connection with a Covered Master Agreement. Parties will only be able to make this representation after performing due diligence of their agreements to ensure that adherence will not result in unintended consequences.⁴
- Although the Protocol itself cannot be amended by the adhering parties, parties can agree to amend the protocol on a bilateral basis to exclude certain agreements, or modify the Close-out Amount language to accommodate previously negotiated methodologies. Agreements to enter into bilateral amendments, however, should be done prior to adherence, or a party may find itself facing an uncooperative counterparty who prefers Close-out Amount.
- The changes in the Protocol include Annexes that reach beyond the early termination provisions in the 1992 ISDA Master Agreement. One annex, for example, alters the basis on which individual equity derivative transactions are closed out following a disruption event. Allowing these transaction-specific provisions to be overridden could disrupt their intended economic consequences and introduce operational risk. The Protocol will apply to all the Annexes listed⁵ unless one of the parties to a Covered Master Agreement specifically elects to not have Close-out apply to any of the Annexes listed. In order to apply or disapply only a subset of the Annexes, parties would have to bilaterally agree outside of the Protocol.
- A 1992 ISDA Master Agreement that has been modified by the Protocol will not be covered by the current ISDA netting opinions. ISDA has said that it intends to commission updates to the opinions to confirm their applicability, but regulated institutions may need to wait for those revised opinions before adhering. There is no timeline for when these updated netting opinions will be available to Protocol adherents.
- The Close-out Amount provision does not fit seamlessly into the current structure and language of the standard Credit Support Annex. Although ISDA has provided standard amendment provisions to bridge the terminology gap between the agreements, the amendments do not address standard dispute resolution methodology, which will continue to rely on market quotations. The Protocol will apply to all the Credit Support Annexes listed,⁶ and cannot be disappplied in adherence. To date,

⁴ Note that any third party credit support documentation (whether or not defined as a Credit Support Document under a Covered Master Agreement) given on terms that expressly require the consent of the third party to any amendment to the Master Agreement are excluded from the Protocol and will have to be amended by a tri-party amendment agreement which includes the third party credit support provider).

⁵ 1994 ISDA Equity Option Definitions and 1996 ISDA Equity Derivatives Definitions
 1997 ISDA Government Bond Option Definitions
 1998 FX and Currency Option Definitions and 1998 Supplement to the 1991 ISDA Definitions
 1999 ISDA Credit Derivatives Definitions
 2000 ISDA Definitions and 2006 ISDA Definitions
 2005 ISDA Commodity Definitions

⁶ 1994 ISDA Credit Support Annex (Bilateral Form; ISDA Agreements Subject to New York Law Only)
 1995 ISDA Credit Support Annex (Bilateral Form–Transfer; ISDA Agreements Subject to English Law)
 1995 ISDA Credit Support Deed (Bilateral Form–Security Interest; ISDA Agreements Subject to English Law)

relatively little attention has been given to Credit Support Annex implications of adopting the Close-out Amount methodology, but this may change as millions of dollars of collateral are exchanged every day and disputes regarding collateral demands are attracting more attention from market participants and regulators. (A copy of the previous Sutherland Legal Alert on valuation disputes is available [here](#).)

- Finally, the Protocol is designed to be irrevocable, so that after a party adheres, it will be held to using Close-out Amount for all agreements entered into prior to adherence, with a very limited time window to revoke.

Conclusion

Unfortunately, there is no data from the Lehman bankruptcy analyzing the prices at which parties were able to terminate their transactions under each of the available methodologies; thus we likely will never know which proved to be the most “reasonable” under such stressed circumstances. Fortunately, the Protocol, in contrast to previous ISDA protocols, is meant to be “evergreen.” As an evergreen protocol, the Close-out Amount Protocol will remain open and parties do not have to rush to adhere without taking the time to think through the issues applicable to their specific circumstances. Although the Protocol is voluntary, according to ISDA’s counsel, and only market participants who are comfortable with the Close-out Amount provisions are encouraged to adhere, the push for adherence by all market participants may gather steam fairly quickly.

We will continue to monitor the progress of the Close-out Protocol and keep you apprised of any relevant developments. Please contact your Sutherland attorney with any questions you may have and to discuss whether it is appropriate for you to adhere.



If you have any questions regarding this Legal Alert, or the services we provide, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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1995 ISDA Credit Support Annex (Bilateral Form–Loan and Pledge; Security Interest Subject to Japanese Law) and 2008 ISDA Credit Support Annex (Loan /Japanese Pledge)
2001 ISDA Margin Provisions