



Via Electronic Mail

August 7, 2009

Mr. Julian Day (jday@isda.org)
Ms. Nichole Framularo (nframularo@isda.org)
International Swaps and Derivatives Association, Inc.
One Bishops Square
London EI 6AD
ENGLAND

Re: MFA Comments on Proposed 2009 ISDA Protocol for Resolution of Disputed Collateral Calls

Dear Mr. Day and Ms. Framularo:

Managed Funds Association (“MFA”)¹ appreciates the opportunity to comment on the proposed 2009 ISDA Protocol for Resolution of Disputed Collateral Calls (the “DR Proposal”) submitted to the Federal Reserve Bank of New York on July 15, 2009. MFA members are active participants in the over-the-counter (“OTC”) derivatives markets. Consequently, the terms that govern parties’ collateral arrangements in these markets and the methods employed to resolve collateral call disputes are of paramount importance to MFA members.

MFA Strongly Supports Industry Efforts to Improve Collateral Dispute Resolution Processes

Since the industry committed to develop improved methods for resolution of disputed margin calls in its October 31, 2008 letter to regulators, MFA and many of its members have been actively engaged in industry discussions and efforts to meet this commitment. MFA and its members strongly support the undertakings by the ISDA Collateral Committee in this regard and firmly believe that all market participants will benefit from methods that will allow parties to resolve collateral disputes more efficiently and on a mutually acceptable basis.

Parts 1 – 4(a) of the DR Proposal detail important enhancements to the dispute resolution processes currently included in ISDA’s Credit Support Annexes. In particular, MFA believes that regular portfolio reconciliation, combined with desk-to-desk discussions and the specified informal mutual dispute resolution methods, will resolve the large majority of collateral call disputes.

MFA also supports the use of market-based solutions for resolving valuation disputes where there is an active market for a disputed product or transaction. Obtaining “Market Maker Quotes” and “Reference Quotes” (as such terms are defined in the DR Proposal) makes sense

¹ MFA is the voice of the global alternative investment industry. Our members include professionals in hedge funds, fund of funds and managed futures funds. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members represent the vast majority of the largest hedge fund groups in the world that manage a substantial portion of the approximately \$1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington D.C. with an office in New York, NY.

where an active, functioning market for a product exists; *i.e.*, where there are sufficient buyers and sellers to establish reliable third party pricing data. However, it is by definition not possible to implement a market-based solution where no active market exists for a product. The key challenge, therefore, is to develop objective resolution methods for valuation disputes in inactive markets.

MFA’s Concerns with the Proposed Formal Dispute Resolution Methods

The DR Proposal effectively provides that, if no third party quotes are available for a disputed transaction, then a “Market Maker Quote” submitted by a single party to the transaction in dispute will prevail in determining the collateral call – even if that quote is not the subject of any market activity to validate its reliability.² As a result, where a market is inactive, a dealer’s valuation will be presumed to be correct if it posts a Market Maker Quote based on that valuation.³ If the dealer’s counterparty believes the dealer’s quote is not reliable, the DR Proposal offers only limited means of redress – *e.g.*, it may increase or close out its position at the dealer’s quoted levels.⁴ None of the proffered “rebuttal” alternatives result, however, in an objective resolution of the valuation dispute in question.

MFA believes this approach fails to ensure a satisfactory resolution of a valuation dispute in an inactive market. This issue is significant as valuation disputes are more likely to arise when markets are illiquid or dysfunctional, as recent experience has shown. As a policy matter, a dispute resolution process that allows the unilateral action of a single, interested party to determine the valuation that will prevail is highly unlikely to be acceptable to MFA’s members. The risk that such a determination could be inaccurate or unreliable is material and not one that should be borne by non-dealer counterparties when more objective alternatives exist.

MFA Maintains that Objective Formal Dispute Resolution Methods Are Essential

MFA maintains that the buy and sell-sides of the market should continue to work together to develop equitable and objective means of resolving collateral call disputes in illiquid markets. In particular, MFA recommends that the relevant working groups reconsider the following approaches where no third-party quotes are available to resolve a valuation dispute:

- (a) Using third-party indicative quotations to resolve the dispute, as contemplated in 6.4(iv)(d) of the DR Proposal (in the scenario where neither party is a “Market Making Party”);

² See Section 6.4(iv)(c)(ii) of the DR Proposal.

³ The DR Proposal does not yet define Reference Market-maker and therefore who is eligible to submit Market Maker Quotes. However, recent working group discussions indicate that this term is intended to be limited to dealers. In this regard, please see our comment on page 3 regarding the definition of Reference Market-maker.

⁴ MFA maintains that it is not appropriate to require a party to either terminate or increase its position merely to address a valuation dispute. Rather, the DR Proposal should focus on establishing a fair valuation while allowing a party to maintain the position for which it contracted “as is”. In addition we do not consider the ability to “sleeve” a two-way quote *via* another dealer as a meaningful means of rebuttal to a Market Maker Quote in an inactive market because other dealers are unlikely to be willing to offer such a service in respect of customized trades or illiquid/stressed markets (*i.e.*, the very scenarios where effective means of rebuttal will be needed).

(b) Taking into account any excess collateral (or “Independent Amount”) posted by a party in respect of a disputed trade (*e.g.*, if the Independent Amount posted by a party in respect of a disputed trade exceeds the disputed amount, that party’s valuation should govern until objective pricing data is available); and

(c) Appealing to a third-party expert/arbitration panel or valuation service to resolve the dispute.

MFA believes that the third party expert/arbitration approach would have clear benefits over the DR Proposal’s approach. Notably an objective third party would not be influenced by self-interest and could be required to make a binary choice between the valuations advocated by the two parties to a disputed trade. By requiring a binary choice to be made, a third-party expert/arbitration method should not entail undue delay in resolving a collateral call dispute.

MFA believes that a satisfactory outcome on the above issues is essential to ensuring broad-based market support for the DR Proposal. As currently drafted, the DR Proposal does not provide adequate safeguards to non-dealer counterparties that have legitimate valuation disputes in respect of products that are not actively traded. As noted above, these disputes are more likely to arise when markets become illiquid or stressed – which is when effective dispute resolution mechanisms will be needed most.

Other Issues

MFA would also like to make the following recommendations and observations in respect of the DR Proposal, some of which are related to the issues raised above:

1. The definition of “Reference Market-maker” should have clear standards and encompass all market participants that are willing to make two-way, firm executable quotations for a particular product – *i.e.*, it should not be limited to leading dealers (as provided in the 1992 ISDA Master Agreement).⁵ If non-dealers were entitled to provide Market Maker Quotes as part of the formal dispute resolution process, it would reduce the circumstances in which only one party’s quote is available to resolve the dispute, and therefore the issues associated with Section 6.4(iv)(c)(ii) would arise less frequently.
2. MFA believes that dealers holding themselves out as market-makers in a particular product should have a greater duty to provide two-way, firm executable quotations to assist in resolving a collateral dispute than is currently contemplated in the DR Proposal.⁶ Specifically, footnote 22 states that a market-maker’s commitment “is only to contribute a price, not necessarily a two-way, firm, executable price”. By qualifying the commitment in this way, the DR Proposal makes it far more likely that the only firm, two-way quote available will be that of a dealer that is party to the disputed trade itself, thereby raising the issues discussed above in respect of Section 6.4(iv)(c)(ii).

⁵ We understand that the Phase 2 working group has acknowledged that the 1992 ISDA Master Agreement definition of Reference Market-maker will not work for purposes of the DR Proposal for a variety of reasons, so another defined term will most likely be needed.

⁶ See Section 6.3(xii) of the DR Proposal.

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3. In Sections 6.4(iv)(b) and (c), it should be made clear that if a party to the disputed trade actually executes a transaction at one of the published quotations, the price at which the trade was executed should prevail for purposes of resolving the valuation dispute.
4. There should be clear sanctions for a party that offers a quotation yet fails to execute against it upon request for reasons other than legitimate credit concerns.⁷ At a minimum, such failures should be reported to relevant industry regulators.
5. Except in clear circumstances where a credit event is imminent, a party should be able to expand the time period available for gathering quotations in respect of more complex trades (as one business day is inadequate for this task).

MFA is committed to working with ISDA and its members to find an effective way to resolve any outstanding uncertainties in the DR Proposal and to meet the industry's commitments to the regulators. As a result, we would be happy to discuss any of the issues raised above at your convenience. Please feel free to contact my colleague, Carl Kennedy, at 202.367.1140.

Sincerely,

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Stuart J. Kaswell
Executive Vice President & General Counsel

⁷ See Section 6.3(xi) of the DR Proposal.