Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives

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Contents

	Page
Part I: Introduction	**1**
Part II: Risk Mitigation Standards	**5**
Standard 1: Scope of coverage	**5**
Standard 2: Trading relationship documentation	**6**
Standard 3: Trade confirmation	**8**
Standard 4: Valuation with counterparties	**10**
Standard 5: Reconciliation	**12**
Standard 6: Portfolio compression	**13**
Standard 7: Dispute resolution	**14**
Standard 8: Implementation	**15**
Standard 9: Cross-border transactions	**16**
Annex 1: Possible material terms for confirmation	**18**

Part I: Introduction

i. This final document presents the risk mitigation standards for non-centrally cleared over-the-counter (OTC) derivatives from the International Organization of Securities Commissions (IOSCO). IOSCO has developed these standards in consultation with the Basel Committee on Banking Supervision (BCBS) and the Committee on Payments and Market Infrastructures[1] (CPMI). In September 2014, IOSCO released the proposed standards for consultation. The comments received from the consultation have been considered in finalising the standards.

Background

ii. The financial crisis that began in 2007 exposed considerable weaknesses in the OTC derivatives market. In 2009, G20 Leaders announced a reform programme to strengthen the resilience of the OTC derivatives market.[2] The global OTC derivatives market has continued to grow, with the Bank for International Settlements estimating that at the end of 2013, the notional amount of outstanding contracts totalled US$710 trillion, compared to US$633 trillion at the end of 2012.[3]

iii. One of the key components of the reform programme was to encourage the central clearing of standardised OTC derivatives. However, not all OTC derivatives are suitable for central clearing. In 2011, G20 leaders asked international standard setters to develop standards on margin requirements for non-centrally cleared OTC derivatives. Exchanging margin reduces counterparty credit risk and limits contagion by ensuring that collateral is available to offset losses caused by the default of a derivatives counterparty. In September 2013, IOSCO and the BCBS released the final framework, which establishes the minimum standards on margin requirements for non-centrally cleared OTC derivatives.[4]

iv. Alongside margin, a number of other techniques may contribute to reducing the risks in the non-centrally cleared OTC derivatives market. These other techniques include documentation, confirmation, portfolio reconciliation and compression, valuation, and dispute resolution. Some jurisdictions have proposed or adopted regulatory requirements

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1 The Committee on Payment and Settlement Systems (CPSS) changed its name to the Committee on Payments and Market Infrastructures (CPMI) on 1 September 2014.

2 G20, Pittsburgh summit declaration, www.g20.utoronto.ca/2009/2009communique0925.html.

3 Bank for International Settlements, "OTC derivatives statistics at end-December 2013" (2014), page 2.

4 *Margin Requirements for Non-Centrally Cleared Derivatives*, Report of the Basel Committee on Banking Supervision and the Board of IOSCO. Sep 2013, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf.

in these areas. Others are considering introducing similar requirements, across these areas or only in certain of these areas.

v. The market for derivatives is global in scope. Market participants frequently deal with counterparties on a cross-border basis. Regulatory standards on risk mitigation techniques for non-centrally cleared OTC derivatives should be sufficiently compatible across jurisdictions to limit regulatory arbitrage, maintain a level playing field and avoid situations where the same transactions are subject to conflicting rules.

Objectives of Risk Mitigation Techniques

vi. Risk mitigation techniques for non-centrally cleared OTC derivatives have three main benefits:

- Promoting legal certainty and facilitating timely dispute resolution: Risk mitigation techniques, such as documentation, confirmation and portfolio reconciliation, are important tools to promote legal certainty for non-centrally cleared OTC derivatives transactions. These techniques help ensure that there is an accurate and definitive written record of the terms of a transaction. Legal certainty over the terms of the transaction forms the basis of the contractual relationship between the counterparties. In the event of a dispute, such legal certainty, together with a pre-agreed dispute resolution mechanism, could prevent the dispute from escalating and facilitate its resolution.

- Facilitating the management of counterparty credit[5] and other risks: Risk mitigation techniques also facilitate the management of counterparty credit and other risks faced by market participants. Many non-centrally cleared OTC derivatives agreements contain clauses related to the management of counterparty credit risk, such as valuation of the non-centrally cleared OTC derivatives transaction, exchange of collateral and close-out netting in the event of default. Ensuring that these provisions are properly documented will promote legal enforceability and facilitate the effective functioning of such counterparty credit risk management arrangements. In addition, by terminating and replacing substantially similar transactions with a smaller number of transactions of decreased notional value, portfolio compression could potentially reduce operational risks,[6] as well as counterparty credit risk exposure. Finally,

[5] Counterparty credit risk is the potential that one or both counterparties will fail to meet their obligations to each other in accordance with the agreed upon terms of OTC derivatives transactions or portfolio of transactions.

[6] Operational risk is the failure to detect, identify, reconcile and promptly correct deficiencies in operating and information systems and processes that could result in the reduction, deterioration or breakdowns of services. Such failures may lead to delays, losses, and liquidity problems. In addition,

portfolio reconciliation helps to mitigate operational risks by ensuring that portfolios accurately reflect the ongoing trading relationship between counterparties.

- Increasing overall financial stability: Many of the key participants in the non-centrally cleared OTC derivatives market are highly interconnected financial institutions. Given this interconnectedness and the systemic importance of certain key participants, sound risk management of non-centrally cleared OTC derivatives by these entities with their counterparties would increase the overall stability of the financial system.

Overview of Standards

vii. As described in more detail in Part II, this paper presents IOSCO's standards for risk mitigation techniques for non-centrally cleared OTC derivatives, as articulated through the following standards:

Standard 1: Scope of Coverage
Financial entities and systemically important non-financial entities (hereinafter referred to as "covered entities") that engage in non-centrally cleared OTC derivatives should employ risk mitigation techniques consistent with the standards set out in this report.

Standard 2: Trading Relationship Documentation
Covered entities should establish and implement policies and procedures to execute written trading relationship documentation with their counterparties prior to or contemporaneously with executing a non-centrally cleared OTC derivatives transaction. Such documentation should include all material terms governing the trading relationship between the counterparties.

Standard 3: Trade Confirmation
Covered entities should establish and implement policies and procedures to ensure the material terms of all non-centrally cleared OTC derivatives transactions are confirmed as soon as practicable after execution of the transaction.

Standard 4: Valuation with Counterparties
Covered entities should agree on and clearly document the process for determining the value of each non-centrally cleared OTC derivatives transaction at any time from the execution of the transaction to the termination, maturity, or expiration thereof, for the purpose of exchanging margins.
Standard 5: Reconciliation

operational deficiencies may reduce the effectiveness of measures that market participants may take to manage risk.

Covered entities should establish and implement policies and procedures to ensure that the material terms and valuations of all transactions in a non-centrally cleared OTC derivatives portfolio are reconciled with counterparties at regular intervals.

Standard 6: Portfolio Compression
Covered entities should establish and implement policies and procedures to regularly assess and, to the extent appropriate, engage in portfolio compression.

Standard 7: Dispute Resolution
Covered entities should agree on the mechanism or process for determining when discrepancies in material terms or valuations should be considered disputes, as well as how such disputes should be resolved as soon as practicable. The mechanism or process should provide for the prompt notification to authorities of such disputes that remain unresolved after a reasonable period of time if the applicable regulation requires such notification.

Standard 8: Implementation
Authorities should implement the standards described in this paper as soon as practicable.

Standard 9: Cross-border Transactions
The different regulatory regimes should interact so as to minimise inconsistencies in risk mitigation requirements for non-centrally cleared OTC derivatives across jurisdictions.

viii. In developing the proposals, the working group carried out a survey to gather information about member jurisdictions' existing or proposed approaches to risk mitigation standards. The results of the survey show that several jurisdictions already impose some risk mitigation requirements on non-centrally cleared OTC derivatives. Notably, the authorities in the EU and the US CFTC have implemented risk mitigation requirements specifically for non-centrally cleared OTC derivatives. Other authorities impose risk mitigation requirements as part of a broader prudential or risk management regulatory requirement, or as part of the business conduct regulation of brokers and dealers (e.g. the requirement to send a confirmation). The risk management requirements that apply in these situations are typically applied broadly and not limited to non-centrally cleared OTC derivatives. The standards recommended in this report are directed at non-centrally cleared OTC derivatives.

ix. In this report, each standard is accompanied by key considerations that describe how the standard should be implemented. Authorities should seek to introduce regulatory requirements or guidance implementing each standard in a way that is consistent with the key considerations. Explanatory notes to the standards provide further elaboration on the standards and key considerations, and explain the rationales behind them.

Part II: Risk Mitigation Standards

Standard 1: Scope of Coverage

Standard

Financial entities and systemically important non-financial entities (hereinafter referred to as "covered entities")[7] that engage in non-centrally cleared OTC derivatives should employ risk mitigation techniques consistent with the standards set out in this report.

Key considerations

1.1 The precise definition of covered entities will be determined by appropriate authorities through national regulation.

1.2 Each authority should at a minimum apply the risk mitigation standards to covered entities in a manner consistent with the authority's application of the margin requirements for non-centrally cleared OTC derivatives.

1.3 Only non-centrally cleared OTC derivatives transactions between two covered entities are subject to the standards in this report.

Explanatory notes

1.4 Risk mitigation techniques promote legal certainty, reduce risk and improve efficiency. To maximise the reduction of systemic risk, the risk mitigation standards for non-centrally cleared OTC derivatives set out in this report should be applied as broadly as practicable amongst market participants. Authorities may require the use of risk mitigation techniques in a proportionate manner depending on the level of risk concentration or activity undertaken by market participants. For instance, to the extent that dealers play a central role in the market, some authorities may decide to achieve broad application by requiring dealers to employ the risk mitigation techniques. Alternatively, authorities may decide to achieve broad application by requiring any market participant using non-centrally cleared OTC derivatives to apply risk mitigation standards, in a manner that is calibrated and proportionate to its activity.

1.5 Certain risk mitigation techniques such as trading relationship documentation, trade confirmation, portfolio reconciliation, valuation with counterparties, and dispute

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[7] For the avoidance of doubt, the terms "financial entity" and "systemically important non-financial entity" do not refer to a market infrastructure, such as a trade repository, not acting as a counterparty.

resolution may form the basis for determining the amount of margins that need to be posted with or collected from the counterparty. The risk mitigation standards thus, at a minimum, should be imposed on covered entities in a manner consistent with the authority's application of the margin requirements for non-centrally cleared OTC derivatives.

1.6 The standards in this report apply to non-centrally cleared OTC derivatives transactions between two covered entities. For transactions between covered entities and non-covered entities, covered entities are encouraged to meet the relevant standards in this report taking into account the nature of the transaction and counterparty.

1.7 Covered entities may employ third-party service providers to perform the risk mitigation techniques required to meet the standards. If so, the covered entities should conduct proper due diligence, both at the outset and on a periodic basis, to assess the capability and reliability of the service providers as well as any risks arising from the use of such service providers. Although the standards do not prohibit covered entities from employing third-party service providers to achieve compliance, the ultimate responsibility for meeting the standards cannot be delegated.

Standard 2: Trading Relationship Documentation

Standard

Covered entities should establish and implement policies and procedures to execute written trading relationship documentation with their counterparties prior to or contemporaneously with executing a non-centrally cleared OTC derivatives transaction.[8] Such documentation should include all material terms governing the trading relationship between the counterparties.

Key considerations

2.1 Trading relationship documentation should provide legal certainty for non-centrally cleared OTC derivatives transactions.

2.2 Trading relationship documentation should include all material rights and obligations of counterparties concerning the non-centrally cleared OTC derivatives trading relationship that have been agreed between them. Such rights and obligations of the

[8] In this context, "execution" of a transaction refers to an agreement by the counterparties to the terms of the transaction that legally binds the counterparties to such terms under applicable law.

counterparties may be incorporated by reference to other documents in which they are specified.

2.3 Trading relationship documentation should be executed in writing or through other equivalent non-rewritable, non-erasable electronic means (without prejudice to the second sentence in paragraph 2.2). In the case of one-off transactions, trading relationship documentation could take the form of a trade confirmation that includes all material rights and obligations of the counterparties to the non-centrally cleared OTC derivatives transactions, which have been agreed between them.

2.4 Covered entities should establish and implement policies and procedures to maintain trading relationship documentation for a reasonable period and make it available promptly upon the request of a relevant regulatory authority or any representative thereof.

Explanatory notes

2.5 The non-centrally cleared OTC derivatives market has traditionally been characterised by privately negotiated transactions entered into by two counterparties. Trading relationship documentation may help to reduce the legal and other risks that can result from undocumented non-centrally cleared OTC derivatives transactions or undocumented material terms of non-centrally cleared OTC derivatives transactions. Some form of trading relationship documentation has been used by the majority of derivatives market participants for many years.

2.6 The content of trading relationship documentation will depend on the type of market participant and class of non-centrally cleared OTC derivatives transactions covered by it. Therefore, it may not be appropriate for authorities to prescribe a universal form of documentation. However, trading relationship documentation should include all material rights and obligations of the counterparties to non-centrally cleared OTC derivatives transactions to help promote legal certainty, which in turn would be expected to support its risk mitigating benefit, and facilitate resolution of potential disputes between counterparties. Such rights and obligations may include but are not limited to any payment obligations, netting of payments, events of default or other termination events,[9] calculation and any netting of obligations upon termination, transfer of rights and obligations, governing law, processes for valuation (see Standard 4), portfolio reconciliation (see Standard 5) and dispute resolution (see Standard 7), credit support arrangements containing any initial and variation margin requirements, types of assets that may be used for satisfying such margin requirements and any asset

[9] For instance, any rights to early termination.

valuation haircuts, investment and rehypothecation terms for assets posted to satisfy such margin requirements, guarantees, and custodial arrangements for margin assets, including whether margin assets are to be segregated with a third party custodian. Any agreement must be consistent with any applicable law or regulation.

2.7 Covered entities should establish and implement policies and procedures to maintain trading relationship documentation for a reasonable period, which should minimally be for a specified period after the termination, maturity or assignment of the non-centrally cleared OTC derivatives transactions which are subjected to such documentation. Covered entities also may consider having an independent internal or external auditor conduct periodic reviews of its documentation policies and procedures.

Standard 3: Trade Confirmation

Standard

Covered entities should establish and implement policies and procedures to ensure the material terms of all non-centrally cleared OTC derivatives transactions are confirmed as soon as practicable after execution of the transaction.

Key considerations

3.1 Confirmation should be done in writing via non-rewritable, non-erasable automated methods where it is reasonably practicable for the relevant counterparties to the transaction to do so. Otherwise confirmation should be done in writing via manual means (such as fax) or other non-rewritable, non-erasable electronic means (such as email).

3.2 Authorities may specify the deadlines for completion of confirmations. Deadlines for completion of confirmations may vary according to factors such as the nature of the counterparty or transaction, or whether the counterparties are in different time zones.

Explanatory notes

3.3 For many years, derivatives market participants have focused on confirmation as an important post-trade processing mechanism that helps to improve legal certainty of the material terms of non-centrally cleared OTC derivatives transactions as well as

operational efficiency.[10] Following the 2007-09 financial crisis, the number of non-centrally cleared OTC derivatives transactions confirmed via electronic, automated or other means has continued to increase. It is important for these trends to continue.

3.4 Confirmation of non-centrally cleared OTC derivatives transactions is critical to enhance downstream operational risk management, including accurate valuations, risk exposure assessments, margin requirements calculations, and discharge of settlement obligations. It also allows for early identification of discrepancies in the terms of non-centrally cleared OTC derivatives transactions, thereby assisting in more prompt resolution of such discrepancies. By promoting legal certainty and operational efficiency, timely trade confirmation can help to ensure safe and efficient financial markets.

3.5 The material terms of a non-centrally cleared OTC derivatives transaction should be confirmed. Material terms confirmed should include terms necessary to promote legal certainty to the transaction, including incorporating by reference, the trading relationship documentation or any other documents that govern or otherwise form part of the trading relationship agreement. A list of possible material terms are set out in **Annex 1**. In addition, in the case of one-off transactions, a confirmation that includes all of the material rights and obligations of the counterparties to the transaction (such as those outlined in explanatory note 2.6) and all of the material terms of the transaction would meet the standard for trading relationship documentation (i.e. Standard 2) and this standard on trade confirmation.

3.6 Transactions should be confirmed as soon as practicable after the parties have executed the transaction. Negative affirmation may be used as long as it is not prohibited under the applicable laws and regulations of a jurisdiction, and the outcome of the confirmation is legally binding on both parties. Authorities may seek to impose specific deadlines for confirmations under regulatory requirements or guidance. The period within which confirmation is required to be completed may vary according to factors such as the nature of counterparties, whether the transaction is standardised or not, whether the counterparties are in different time zones, and whether automated confirmation is available.

3.7 The entry into a transaction, including a new transaction resulting from novation, should be confirmed. Covered entities should also consider adopting policies and procedures to confirm material changes to the legal terms, or rights and obligations under the transaction. Such changes may include termination prior to scheduled

[10] U.S. Government Accountability Office, "Credit Derivatives: Confirmation Backlogs Increased Dealers' Operational Risks, But Were Successfully Addressed After Joint Regulatory Action," GAO-07-716 (2007) at pages 3-4.

maturity date, assignment, novation, amendment or extinguishing of rights or obligations.

3.8 Authorities also may consider specifying in regulatory requirements or guidance whether transactions that remain unconfirmed after a specified period should be reported to the relevant authority. Such information may assist authorities in their monitoring of the OTC derivatives market, such as identifying in a timely manner emerging risks in institutions or types of products.

Standard 4: Valuation with Counterparties

Standard[11]

Covered entities should agree on and clearly document the process for determining the value of each non-centrally cleared OTC derivatives transaction at any time from the execution of the transaction to the termination, maturity, or expiration thereof, for the purpose of exchanging margins.

Key considerations

4.1 Covered entities should agree on, and document in writing, the process that the counterparties will rely upon for making valuation determinations in a predictable and objective manner. Such process should be reasonably designed to avoid disputes; however, should a dispute on valuation arise, covered entities should agree on how such disputes should be resolved as set out under Standard 7.

4.2 The valuation determinations should be based on economically similar transactions or other objective criteria.[12] The valuation may be computed internally or provided by third parties.

4.3 All agreements on valuation process should be documented in the trading relationship documentation or trade confirmation. A process for determining the valuation should be in place for the entire duration of the non-centrally cleared OTC derivatives transaction.

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[11] This standard relates to the common valuation process adopted by the counterparties to the OTC derivatives transaction for the purpose of exchanging margins. The valuation process used for internal risk management purpose is not covered by this standard.

[12] No OTC derivatives market participant should be required to disclose to its counterparty confidential and/or proprietary information about, or used in, any model it may use to value an OTC derivatives transaction.

4.4 Covered entities should perform periodic review of the agreed-upon valuation process to take into account changes in market conditions. Where changes are made as a result of the review, the relevant documentation should be updated to reflect such changes.

Explanatory notes

4.5 OTC derivatives valuation disputes have long been recognized as a significant problem in the OTC derivatives market.[13] The inability to agree on the value of OTC derivatives became especially acute during the 2007-2009 financial crisis when there was widespread failure of the market inputs needed to value many transactions.[14] The ability to determine the value of an OTC derivatives transaction at any given time lies at the centre of many OTC derivatives reform efforts and is a cornerstone of risk management. OTC derivatives transaction valuation is crucial for determining margin requirements and therefore plays a primary role in risk mitigation for non-centrally cleared OTC derivatives transactions.

4.6 Valuation of non-centrally cleared OTC derivatives is not always an easy task. For instance, for frequently traded non-centrally cleared OTC derivatives transactions, there is often widespread agreement on the valuation process, including the prices to be used in the valuation process. However, for thinly traded non-centrally cleared OTC derivatives transactions, there is often no common agreement on the valuation process.

4.7 Agreement between counterparties on the general process for valuation (e.g. the approach, the key parameters, and the data sources for such parameters) will assist in determining the margin amounts and minimizing valuation discrepancies, thereby reducing risk.

4.8 Valuation documentation should include an alternative process or approach by which counterparties will determine the value of the non-centrally cleared OTC derivatives transaction in the event of the unavailability or other failure of any inputs required to value the transaction. Counterparties may agree on changes or procedures for modifying or amending the valuation process or approach at any time so long as the agreements remain consistent with applicable law.

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[13] See ISDA Collateral Committee, "Commentary to the Outline of the 2009 ISDA Protocol for Resolution of Disputed Collateral Calls," (2 June 2009) (stating "Disputed margin calls have increased significantly since late 2007, and especially during 2008 have been the driver of large (sometimes > $1 billion) un-collateralized exposures between professional firms").

[14] The failure of the market to set a price for mortgage-backed securities led to wide disparities in the value of CDS referencing mortgage-backed securities (especially collateralized debt obligations). Such widespread disparities led to large collateral calls from dealers on AIG, hastening its downfall. See CBS News, "Calling AIG? Internal Docs Reveal Company Silent About Dozens of Collateral Calls" (23 June 2009), available at http://www.cbsnews.com/news/calling-aig/.

Standard 5: Reconciliation

Standard

Covered entities should establish and implement policies and procedures to ensure that the material terms and valuations of all transactions in a non-centrally cleared OTC derivatives portfolio are reconciled with counterparties at regular intervals.

Key considerations

5.1 To identify and facilitate resolution of discrepancies between counterparties, and achieve effective risk management, covered entities should reconcile, at regular intervals, the material terms and valuations of non-centrally cleared OTC derivatives transactions, both collateralized and uncollateralized, in their portfolios with counterparties.

5.2 Covered entities should agree on the process or method of portfolio reconciliation.

5.3 The reconciliation should be designed to ensure an accurate record of the material terms and valuations of the non-centrally cleared OTC derivatives transactions in the portfolio, and to identify and resolve discrepancies in the material terms and valuations in a timely manner. Portfolio reconciliation should encompass all transactions in the portfolio.

Explanatory notes

5.4 Disputes related to OTC derivatives terms and valuations have long been recognized as a significant problem in the OTC derivatives market.[15] Portfolio reconciliation is considered an effective means of identifying and resolving these disputes. By identifying and managing mismatched material terms and valuations of non-centrally cleared OTC derivatives transactions, a process can be created whereby counterparty credit and other risks can be identified and decreased. Portfolio reconciliation is a post-execution processing and risk management technique designed to: (i) identify and resolve discrepancies between counterparties regarding material terms; (ii) ensure effective confirmation has taken place and the continued accuracy of records of material terms; and (iii) identify and promote the resolution of discrepancies between counterparties regarding valuations. In some instances, portfolio reconciliation also may facilitate the identification and resolution of material discrepancies between the counterparties with regard to valuations of collateral held as margin.

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[15] See ISDA Collateral Committee, under footnote 13.

5.5 The industry has made significant progress in adopting the use of portfolio reconciliation to reduce the number of OTC derivatives disputes.[16] Reconciliation is beneficial not only to the parties involved but also to the market as a whole. By identifying and managing discrepancies in material terms or valuations for non-centrally cleared OTC derivatives transactions across a portfolio, overall risks can be diminished. Parties also will be able to identify and correct problems in their post-execution processes to reduce the number of disputes and improve the integrity and efficiency of their internal processes.

5.6 Authorities may seek to impose specific frequencies for the conduct of portfolio reconciliation under regulatory requirements or guidance. The frequency at which the reconciliation is required to be conducted may vary according to factors such as the nature of counterparties, or the number or size of the non-centrally cleared OTC derivatives transactions or portfolio outstanding between the counterparties.

Standard 6: Portfolio Compression

Standard

Covered entities should establish and implement policies and procedures to regularly assess and, to the extent appropriate, engage in portfolio compression.

Key considerations

6.1 Compression should seek to replace economically-equivalent transactions by decreasing the number of transactions and/or notional value of a portfolio of non-centrally cleared OTC derivatives transactions and thereby reducing certain risks, e.g. credit risk and operational risk.

[16] In December 2008, the ODSG's group of 14 major dealers committed to execute daily portfolio reconciliations for collateralized portfolios with over 500 trades between dealers by June 2009. See June 2, 2009 summary of industry commitments, available at http://www.isda.org/c_and_a/pdf/060209table.pdf. By May 2009, all participating dealers were satisfying this commitment, and in October 2009, the ODSG committed to a feasibility study on market-wide portfolio reconciliation setting forth how regular portfolio reconciliation could extend beyond ODSG dealers to include smaller banks, buy-side participants, and derivative end users. Consistent with this publication, the ODSG dealers expanded their portfolio reconciliation commitment in March 2011 to include monthly reconciliation of collateralized portfolios above 500 trades with any counterparty, other than affiliates. The industry has also been preparing a new "Convention on the Investigation of Disputed Margin Calls" and a new "Formal Market Polling Procedure" that are intended to "create a consistent and predictable process . . . that eliminates present uncertainties and delays." See "ISDA 2010 Convention on the Investigation of Disputed Margin Calls" and "ISDA 2010 Formal Market Polling Procedure."

6.2 Portfolio compression may be performed on a bilateral or multilateral basis.

Explanatory notes

6.3 Portfolio compression has wide ranging benefits for market participants as well as the market as a whole. Portfolio compression is an important post-trade processing mechanism, which allows derivatives market participants with a sizeable portfolio of non-centrally cleared OTC derivatives transactions between them, to terminate wholly or partially those transactions which have substantially similar economic terms. Where a portfolio compression exercise is properly designed, derivatives market participants may be able, through participation in such an exercise, to reduce risks and transactional inefficiency in their non-centrally cleared derivatives portfolios. Certain risks and inefficiencies may be more pronounced in larger portfolios.

6.4 Portfolio compression may provide a more accurate expression of overall market size and composition. The benefits of portfolio compression also may extend to individual market participants and include: (i) reduced transaction count to decrease operational risk, as there are fewer trades to maintain, process and settle;[17] (ii) reduced outstanding gross notional value of non-centrally cleared OTC derivatives transactions, allowing for increased capital liquidity and efficiency; and (iii) diminished operational risk for individual market participants which may, in turn, lessen systemic risk and enhance overall financial market stability. However, portfolio compression may carry some disadvantages specific to a party's legal, tax, accounting and/or operational status and may therefore not be appropriate in all circumstances.

Standard 7: Dispute Resolution

Standard

Covered entities should agree on the mechanism or process for determining when discrepancies in material terms or valuations should be considered disputes, as well as how such disputes should be resolved as soon as practicable. The mechanism or process should provide for the prompt notification to authorities of such disputes that remain unresolved after a reasonable period of time if the applicable regulation requires such notification.

17 See "ISDA 2009 A Yearbook of ISDA Activities," International Swaps and Derivatives Association, Inc. (2009).

Key considerations

7.1 Covered entities should document their mechanism or process for resolving disputes as to the material terms of a non-centrally cleared OTC derivatives transaction and/or a material difference in its valuation between the counterparties. The mechanism or process should provide for the escalation of material disputes to an appropriate level of senior management at the entity.

7.2 Authorities may consider specifying in regulatory requirements or guidance whether covered entities should report to the relevant authority a valuation dispute in excess of an amount determined by regulation or above a pre-agreed threshold that is not resolved within a reasonable period of time.

Explanatory notes

7.3 When discrepancies in the material terms or valuations of a non-centrally cleared OTC derivatives transaction or portfolio are identified through portfolio reconciliation or otherwise, such discrepancies may lead to disputes between market participants. The resolution of such disputes in a timely fashion is critical to risk management, including the exchange of collateral through margin to cover the risk exposures posed by such OTC derivatives.

7.4 Covered entities should agree on the mechanism or process to be followed in the event of a dispute to ensure that disputes are addressed in a manner agreeable to both parties.[18]

7.5 Authorities may specify the parameters (e.g. the threshold, outstanding period) of regulatory reporting of disputes. Regulatory reporting may facilitate monitoring of the valuation disputes involving larger amounts, and identification of potential risks areas in the market. Covered entities should keep any authorities to whom they make such reports abreast of the progress of dispute resolution.

Standard 8: Implementation

Standard

Authorities should implement the standards described in this paper as soon as practicable.

[18] An agreement on such a mechanism or process would not prevent covered entities from pursuing other options for recourse (e.g. arbitration or legal proceedings).

Key considerations

8.1 Authorities should implement the standards described in this paper as soon as practicable, taking into account timelines for implementation of margin requirements for non-centrally cleared OTC derivatives transactions.

8.2 Authorities may choose to adopt a phase-in approach, such as applying a shorter compliance timeline for certain types of entities.

Explanatory notes

8.3 The BCBS and IOSCO have in September 2013 jointly recommended that the margin requirements for non-centrally cleared OTC derivatives be phased in from 1 December 2015.[19] When implementing the risk mitigation standards, authorities should consider the feasibility of implementing these standards and the margin requirements around the same time.[20]

8.4 Where authorities adopt a phase-in approach for the risk mitigation standards, consideration should be given to the systemic significance of the various types of covered entities and the risks that are left unmitigated during a transition period. Authorities should endeavour to require covered entities that are major players in the market, such as banks, to comply with the risk mitigation requirements as soon as practicable. These entities also would likely have access to more resources to make the operational enhancements needed to move to the new requirements.

Standard 9: Cross-Border Transactions

Standard

The different regulatory regimes should interact so as to minimise inconsistencies in risk mitigation requirements for non-centrally cleared OTC derivatives across jurisdictions.

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[19] The final report can be found at: http://www.bis.org/publ/bcbs261.pdf.

[20] In implementing the standards, authorities may have regard to the time needed by the covered entities to put in place the necessary infrastructure and systems to adhere to the requirements.

Key considerations

9.1 Authorities should closely cooperate when introducing these standards and endeavour to reduce the risks of conflicts and inconsistencies between their regimes with respect to the cross-border application of risk mitigation requirements.

Explanatory notes

9.2 The market for non-centrally cleared OTC derivatives is global in scope. Key derivatives market participants are often engaged in derivatives activity through a variety of legal entities in different national jurisdictions and frequently deal with counterparties on a cross-border basis. Given the global nature of the market, the effectiveness of the risk mitigation requirements could be undermined if inconsistent requirements are adopted. Inconsistent or conflicting requirements also would add to the regulatory burden and costs of compliance for the industry. Authorities should cooperate and coordinate through bilateral or multilateral channels to reduce such issues to the extent possible.

Annex 1: Possible Material Terms for Confirmation[21]

General Terms
1. Trade date
2. Effective date
3. Underlying instrument
4. Termination date
5. Settlement method (cash or physical)
6. Settlement date (and time zone, if multiple currencies are involved)
7. Business day convention
8. Governing law
Asset Class : Credit/Equity
1. Counterparty purchasing the protection
2. Counterparty selling the protection
3. Information identifying the reference entity
4. Notional amount and currency
5. Currency in which notional amount is expressed
6. Amount of initial payment
7. Currency in which initial payment is expressed (where applicable)
8. Payment frequency
9. Spread (where applicable)
Asset Class : FX
1. Currency 1
2. Currency 2
3. Notional amount 1
4. Notional amount 2
5. Exchange rate
6. Payer of currency 1
7. Payer of currency 2

[21] These examples are meant to be illustrations and do not represent an exhaustive or minimum list of confirmation terms.

Asset Class : Interest Rate
1. Notional amount (leg 1)
2. Notional currency (leg 1)
3. Notional amount (leg 2)
4. Notional currency (leg 2)
5. Amount of initial payment
6. Currency in which initial payment is expressed
7. Rate of leg 1
8. Day count of leg 1
9. Rate of leg 2
10. Day count of leg 2
11. Payment frequency of leg 1
12. Payment frequency of leg 2
13. Reset frequency period of leg 1
14. Reset frequency period of leg 2
15. Spread
16. Payer of leg 1
17. Payer of leg 2
Asset Class : Commodity
1. Quantity unit
2. Quantity frequency
3. Total quantity
4. Price unit
5. Price currency
6. Grade
7. Floating rate payer