MACFARLANES

ISDA 2013 EMIR PORTFOLIO RECONCILIATION, DISPUTE RESOLUTION AND DISCLOSURE PROTOCOL

FINANCIAL SERVICES

On 19 July 2013, ISDA published the ISDA 2013 EMIR Portfolio Reconciliation, Dispute Resolution and Disclosure Protocol (the Protocol). The Protocol enables the parties to OTC Derivatives contracts to amend their ISDA Master Agreements (and other similar agreements) (the Covered Agreements) in order to set out the terms for compliance with certain portfolio reconciliation and dispute resolution requirements under the European Markets Infrastructure Regulation (648/2012) (EMIR). The Protocol also includes a disclosure waiver so as to facilitate compliance with EMIR's reporting and record keeping obligations without breaching confidentiality obligations.

WHY ANOTHER PROTOCOL?

While EMIR came into force on 16 August 2012, its requirements are being "phased in" over time. Some of the risk mitigation requirements for non-cleared OTC derivative contracts came into force on 15 March 2013, others will come into force on 15 September 2013.

Amongst other provisions, those coming into force on 15 September 2013 relate to the portfolio reconciliation and dispute resolution requirements for non-cleared OTC derivatives. Consequently, from 15 September 2013 the parties to non-cleared OTC derivative transactions will need to have agreed (in writing) with each other the arrangements under which portfolios will be reconciled and such reconciliations will need to be performed at the specified frequencies (depending on the categorisation of the counterparties for the purposes of EMIR and the number of outstanding transactions between them). The counterparties to non-cleared OTC derivative transactions will also need to have agreed detailed procedures and processes with each other in relation to:

i. the identification, recording and monitoring of disputes relating to the recognition or valuation of contracts and to the exchange of collateral between the counterparties; and

ii. the resolution of disputes in a timely manner with a specific process for those disputes that are not resolved within five business days.

The Protocol is part of ISDA's "tool-kit" to enable parties to comply with these obligations without having to renegotiate their bilateral agreements with each OTC counterparty individually.

WHO DO THE RISK MITIGATION REQUIREMENTS FOR NON-CLEARED OTC DERIVATIVE TRANSACTIONS APPLY TO?

The risk mitigation requirements for non-cleared OTC derivative transactions apply to financial counterparties[1] and non-financial counterparties[2] who enter into OTC derivative transactions which are not cleared by a central counterparty (CCP). The risk mitigation requirements do not apply directly to third country entities (TCEs) but note the following paragraph.

IS THE PROTOCOL RELEVANT TO TCES (I.E. ENTITIES ESTABLISHED OUTSIDE THE EU)?

While TCEs are not directly subject to the risk mitigation requirements for non-cleared OTC derivative contracts, whenever a TCE trades OTC derivatives on a non-cleared basis, with an entity established within the EU, that entity will be subject to the risk mitigation requirements irrespective of whether their counterparty is established within the EU or not. Accordingly, EU counterparties to TCEs are likely to request that TCEs adhere to the Protocol in order to assist the EU counterparty with complying with their EMIR obligations.

WHAT DOES THIS PROTOCOL DO?

The Protocol automatically amends the Covered Agreements entered into between counterparties who have adhered to the Protocol (Adhering Parties) in three ways. It:

i. sets out the terms on which the parties intend to reconcile their trading portfolios;

ii. provides an agreed mechanism for identifying and resolving disputes; and

iii. includes a waiver for breach of confidentiality.

(i) Portfolio Reconciliation

Parties adhering to the Protocol either do so as a "Portfolio Data Sending Entity" or a "Portfolio Data Receiving Entity". If both counterparties have adhered as Portfolio Data Sending Entities, both counterparties will send portfolio data to each other and both will perform the reconciliation process independently.

If one of the parties to a Covered Agreement has adhered as a Portfolio Data Receiving Entity, then that party alone will be responsible for reconciling its own portfolio data with that received from its counterparty. The Protocol provides that if a Portfolio Data Sending Entity has not been notified by the Portfolio Data Receiving Entity of discrepancies in the data within five days, the assumption is that the data is correct.

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[1] A "financial counterparty" means (broadly) MiFID investment firms, EU credit institutions (e.g. banks), EU insurers and reinsurance undertakings, UCITS funds and alternative investment funds whose alternative investment fund managers are authorised for the purposes of the AIFMD.

[2] A "non-financial counterparty" means an undertaking established in the EU other than a financial counterparty or a CCP.

If both counterparties have adhered as Portfolio Data Receiving Entities, an alternative process of reconciliation must be agreed.

In order to avoid bearing the entire burden of reconciliation, those dealers who have already adhered to the Protocol have adhered as Portfolio Data Sending Entities and are keen to advise their clients to adhere as Portfolio Data Receiving Entities. In reality, it is likely that buy-side participants will also adhere as Sending Entities and thus it will become standard practice for both parties to perform the reconciliation process. This means that funds (or their investment managers on their behalf) will need to ensure that they have arrangements in place to reconcile portfolios – this may involve ensuring that sufficient resource is available internally or by appointing a third party (see our comments below regarding consent to the appointment of third parties).

How often must portfolios be reconciled?
The frequency at which a counterparty must perform this portfolio reconciliation process will depend on:

a. its counterparty classification under EMIR; and

b. the number of outstanding non-cleared OTC derivative transactions it has with a particular counterparty.

Portfolios must be reconciled at the very least in accordance with the following prescribed frequencies:

FC and NFC+	
Number of outstanding contracts	Reconciliation frequency
500+	Each business day
51 – 499	Weekly
50 or fewer	Quarterly

NFC-	
Number of outstanding contracts	Reconciliation frequency
101+	Quarterly
100 or fewer	Annually

What data must be sent/exchanged?
Portfolio data should include the key terms of each of the outstanding transactions between the counterparties. This should include, but may not be limited to:

- the effective date;
- the scheduled maturity date;
- payment or settlement dates;
- the notional value of the contract;
- currency of the contract;
- the underlying instrument; and
- the business day convention.

Can the reconciliation function be delegated to a third party?
Yes. When a party adheres to the Protocol it can specify that it will delegate the reconciliation function to an affiliate or a third party. Note, that the text of the Protocol requires that consent must be obtained from each of your OTC counterparties should you wish to delegate to a third party. Importantly, if a fund adheres to the Protocol in its own right, delegation to the fund's investment manager will be viewed as delegation to a third party, thus requiring consent.

While the function of reconciliation can be delegated, to the extent that a counterparty is directly subject to the risk mitigation requirements under EMIR, the regulatory responsibility for performing portfolio reconciliation in compliance with EMIR cannot be delegated to the third party.

(ii) Dispute Resolution
The Protocol provides an agreed framework for the identification, monitoring and resolution of disputes around valuation of non-cleared OTC derivative contracts and the exchange of collateral in relation to those contracts.

What is the Protocol's dispute resolution procedure?
If an Adhering Party identifies an issue that it wishes to dispute with its counterparty, it may send a dispute notice to that counterparty. The parties must then try and resolve the issue in good faith and in a timely manner. This may include using pre-agreed dispute mechanics, such as (for margin disputes) the existing Dispute Resolution procedures contained in the standard Credit Support Annex.

What if the dispute cannot be resolved?
If the dispute has not been resolved within five business days, the Protocol provides that the dispute must be escalated within the counterparties.

Does this procedure override other dispute mechanisms agreed between counterparties?
No. The Adhering Parties are free to resolve the dispute by whatever means they feel appropriate. This includes utilising any pre-agreed dispute mechanics, for example the dispute resolution provisions in the Credit Support Annex.

(iii) Disclosure waiver
The Protocol also includes a disclosure waiver in order to ensure that parties can meet the various reporting and record keeping requirements under EMIR, without breaching confidentiality obligations which may have been previously contractually agreed between the counterparties to OTC derivatives, or are otherwise implied by law.

This duplicates the ISDA 2013 Reporting Protocol (the Reporting Protocol), but whereas the Reporting Protocol disclosure waiver applies to regulatory reporting generally, this is specific to EMIR reporting. Importantly, despite this duplication, a party who has adhered to the Reporting Protocol will still need to consider adhering to this Protocol in order to comply with EMIR's portfolio reconciliation and dispute resolution requirements.

IS THE PROTOCOL OBLIGATORY?

No. There is no obligation for market participants to adhere to the Protocol. That said, parties must find a way to comply with the EMIR requirements. The Protocol is one means of agreeing the terms on which the parties intend to comply. An alternative is for a party to bilaterally negotiate and agree procedures for portfolio reconciliation and dispute resolution with each of its OTC derivative counterparties - a process that could be both lengthy and costly.

IS IT POSSIBLE TO INCORPORATE THE TEXT OF THE PROTOCOL INTO COVERED AGREEMENTS WITHOUT ADHERING?

Yes, as with other ISDA protocols it is possible to incorporate the text of the Protocol into Covered Agreements by reference. We expect some buy-side entities to take this route.

CAN INVESTMENT MANAGERS ADHERE ON BEHALF OF THE FUNDS THEY MANAGE?

Yes, but only to the extent the investment manager has signed the underlying Covered Agreement on behalf of the funds it manages (for example, asset managers under umbrella ISDAs). Investment managers may adhere to the Protocol on behalf of multiple funds on either a disclosed or undisclosed basis.

If a fund has signed its ISDA Master Agreements (or similar agreements) in its own right, the fund itself should adhere to the Protocol.

WHAT IF A COUNTERPARTY HAS NOT ADHERED TO THE PROTOCOL?

The Protocol acts as an amendment to the bilateral Covered Agreements between counterparties to OTC derivative transactions. If one party to the Covered Agreement has not adhered to the Protocol, there can be no agreement to amend the underlying Covered Agreement. In that case, the parties must bilaterally agree in writing the terms on which they will carry out the portfolio reconciliation and dispute resolution obligations.

HOW DOES ADHERENCE WORK?

Parties can adhere by signing an Adherence Letter, a copy of which can be found on ISDA's website[3]. In the Adherence Letter parties must state whether they are adhering as a Portfolio Data Receiving Entity or a Portfolio Data Sending Entity (see above). Note that the selected status will apply to the Adhering Party indefinitely and across all its OTC derivatives counterparties. If an Adhering Party wants to take an alternate status with some of its counterparties, it can change its status via a bilateral written agreement with those counterparties. The other terms of the Adherence Letter cannot be negotiated or amended in any way.

A printed and signed version of the Adherence Letter should be returned to ISDA via PDF. Signed Adherence Letters will not be accepted by post.

ARE THERE ANY COSTS INVOLVED?

Each Adhering Party must pay a one-off adherence fee of $500 to ISDA on, or before, submission of the Adherence Letter. An investment manager adhering on behalf of multiple funds under one Adherence Letter is only required to pay the fee once.

CONTACT DETAILS
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[3] https://www2.isda.org/functional-areas/protocol-management/submit-adherence-letter/15