

ISDA and FIA Execution Agreement, Cleared Derivatives Execution Agreement and Addendum

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Clearing requirements have brought about significant changes to derivatives documentation. While uncleared derivatives continue to be governed by an International Swaps and Derivatives Association (**ISDA**) Master Agreement and a Credit Support Annex, cleared derivatives require further documentation such as: (i) clearing agreements, (ii) give-up agreements, and (iii) collateral transformation agreements.

The derivatives industry has created standard forms to assist with the documentation burden arising from putting clearing arrangements in place and generally to assist with complying with the new rules governing derivatives. Those standard documents include classification letters, delegated reporting agreements (both available from the ISDA website) and client clearing documentation for both US and non-US platforms, as well as a number of protocols and standard amendment agreements.

The purpose of this Practice Note is to describe the key terms the ISDA/Futures Industry Association (**FIA**) Cleared Derivatives Execution Agreement (the '**Agreement**') and the ISDA/FIA Client Cleared over-the-counter (**OTC**) Derivatives Addendum (the '**Addendum**'). Both the Agreement and Addendum are available on ISDA's website.

Role of the Agreement

The Agreement is designed as a template for market participants needing an execution agreement under English law for derivatives that are intended to be cleared by central counterparties (**CCPs**) located *outside* of the US. The Agreement works with the 'principal model' of clearing where the clearing member (**CM**) contracts as principal with the CCP and has a corresponding back-to-back contract with the client. The Agreement:

- sets out the rights and obligations of each counterparty to a trade that is intended for clearing
- describes the process for submitting a trade to a CCP, as well as the fall-back provisions should a transaction not be accepted for clearing; and
- can be used in conjunction with the Addendum

Structure of the Agreement

Main building blocks

The parties to the Agreement:

- represent to each other that each has a clearing agreement with a CM
- agree on steps to be taken if the trade does not clear; and
- agree how breakage payments are determined and paid if a transaction terminates

Clearing procedure

Section 2 of the Agreement sets out the following parameters of the clearing process:

- section 2(a) prescribes that in respect of each derivatives transaction (other than automatically matched trades), both parties have to submit an electronic message to a mutually agreed matching platform
- such submission has to be made as soon as practicable after execution of the derivatives transaction, to enable trade details to be matched and submitted to the CCP
- under section 2(b), the parties must take reasonable steps to ensure that the derivatives transaction is cleared, such as:
 - > resolving matching issues
 - > re-submitting electronic messages
 - > supplying any required information to the relevant CCP
 - > one party's affiliate agreeing to act as a CM for the other party
 - > selection of an alternative CM
 - > selection of an alternative CCP, or
 - > agreeing any other course of action that will achieve clearing

Alternative action where trades are not matched

If, despite the parties' efforts, the details of their trade are not matched or if the CCP rejects the transaction, section 3 of the Agreement sets out the alternative action to be taken.

- Under section 3(a), the parties may agree to treat the trade as a bilateral uncleared transaction, to the extent that it is not subject to mandatory clearing. For that purpose, the parties will need to have an agreement in place regarding any necessary modifications and appropriate bilateral documentation.
- Alternatively, under section 3(b), the 'Terminating Party' (as elected in the Annex to the Agreement) will have the right, within a pre-agreed time period, to terminate the uncleared transaction and to determine the relevant termination amount then due.

Termination amounts

Under section 3(b) of the Agreement, termination is triggered by a 'Relevant Event' (as defined in Section 18) which includes:

- failure to match transactions
- non-acceptance of a transaction by a party's CM
- rejection of a transaction by a CCP, or
- non-acceptance by a CCP by a prescribed cut-off date

Upon the occurrence of a Relevant Event, the designated Terminating Party has the right to determine the Early Termination Amount of the terminated trade and has to notify the other party (with payment then due on the Local Business Day following the day that such notice is effective).

The Early Termination Amount is determined in accordance with the procedure set out in section 6(e) of the 2002 ISDA Master Agreement, with the following modifications: (i) an Additional Termination Event is deemed to have occurred; (ii) the 'material terms' (for the purpose of clause (a) of the definition of 'Close-out Amount' in the 2002 ISDA Master Agreement) include the fact that such transaction was intended to be cleared by the relevant CCP and (iii) the Affected Party is determined by considering which party failed to submit an electronic message to the relevant matching system, or breached any representation or obligation, or violated its credit limits with the CCP.

Other key terms of the Agreement

Under section 4, once a transaction is ‘Registered’—accepted and registered for clearing by a CCP in accordance with the rules of such CCP—then regardless of whether a Relevant Event has occurred in respect of such a transaction, no Early Termination Amount will be payable by either party.

Section 8 of the Agreement contains the limitation on liability which is crucial for CMs to be able to undertake clearing services. Neither party will be liable for negligence, failure of transmission or any other cause beyond its control (unless otherwise provided by the rules of the relevant CCP and by sections 9 (*Termination*), 10 (*Interest*) or 11 (*Expenses*)).

Section 18 contains the defined terms used in the Agreement. Notably:

- *Derivatives Transaction* includes any OTC swap, forward, option or similar transaction between the parties that is subject to the Derivatives Agreement, that both parties have agreed will be submitted for Registration subject to the Agreement, other than any futures and options on futures contracts and other transactions executed in anonymous markets or markets operated as central limit order books.
- *Derivatives Agreement* is the master agreement specified in the Annex.
- *Cleared Transaction* is the cleared derivatives transactions arising upon Registration of a Derivatives Transaction, governed by the applicable Clearing Agreement.
- *Clearing Agreement* in respect of a Cleared Transaction and a party to the Agreement means: (i) if a party is a client of a CM in relation to such Cleared Transaction, the agreement that such party has with its CM governing such Cleared Transaction; or (ii) if a party is a CM in relation to such Cleared Transaction, the applicable arrangements that such party has with the relevant CCP governing such Cleared Transaction.

The Annex

The Annex to the Agreement permits the inclusion of the administrative and notice details of the parties and certain elections relating to:

- the governing ISDA Master Agreement between the client and the CM
- the applicable Local Business Day
- the designation of one party as Terminating Party (this is the party driving the terminations and related calculations), and
- a ‘Termination Long Stop Date’ which ensures that transactions affected by Relevant Events terminate automatically within the specified period

The Addendum

The Addendum is capable of supplementing and forming part of an existing clearing member/client agreement (ISDA, FIA and other master agreements). It operates in conjunction with any non-US CCP that does not require its own form of clearing member/client agreement and in line with the principal-to-principal structure that is predominantly used in Europe. The Addendum creates ‘netting sets’ (groups of transactions that are subject to enforceable netting arrangements) to facilitate close-outs. In turn, the Annex to the Addendum is designed to specify the relevant CCP(s) and covered products and generally, to permit a level of customisation to the clearing arrangement.

The key terms of the Addendum:

- prescribe the automatic pass-through of the cleared trade’s terms and the CCP performance
- set out the rights of the client to transfer positions pre-default of the CM
- deal with the consequences of defaults by the CCP, CM or client
- provide that liability of the CM to the client in relation to the non-performance of the CCP is limited, and the client indemnifies the CM for losses incurred under client transactions with the CCP, and
- are designed to operate alongside the rules, procedures, regulations and policies promulgated by the relevant CCP (a ‘Rule Set’).

Scope—client transactions

Section 3(a) of the Addendum provides that the Addendum forms part of a specified clearing agreement between a CM and its client. The Addendum relates to ‘Client Transactions’—these are the transactions between a CM and its client. The terms of the Client Transaction are identical to those of the related CM/CCP transaction, except that:

- the Client Transaction is subject to the relevant clearing agreement
- the provisions relating to collateral as set out in the specified collateral agreement; and
- under each Client Transaction, the CM takes the opposite position to the position it has under the related CM/CCP transaction

Modification events

One of the key concerns for cleared transactions is the potential mismatch between the client trade and the CCP trade. Section 3(c) of the Addendum operates in such circumstances. A mismatch may occur where the relevant CCP intervenes, or the relevant CM intervenes or the client breaches its obligations. More specifically:

- A 'Modification Trigger Event' (in relation to a CM/CCP transaction) occurs when any event arises (including change in law or any action by governmental authority) or action is taken by or in relation to an agreed CCP. This term excludes: (i) terminations as a result of a CCP default or a CM default, (ii) amendments to the margin methodology made by the relevant CCP and applied to the relevant CM/CCP Transactions, and (iii) actions or omissions by the CM (*except* where the CM has to comply with applicable law or with directions of any governmental authority or Agreed CCP or to react to client breaches).
- The 'Modification Change Events' (in relation to a CM/CCP Transaction) follow from a Modification Trigger Event are circumstances where: (i) the economic terms of the rights, liabilities or exposures of the CM and the CCP under the CM/CCP transaction have been changed and (ii) consequential changes to the related Client Transaction have been made so that there are *no resulting mismatches*.
- The 'Modification Mismatch Events' (in relation to a CM/CCP Transaction) follow from a Modification Trigger Event, are circumstances where the economic terms of the rights, liabilities or exposures of the CM and the CCP have been amended in a way that *results in a mismatch* with the Client Transaction.

The consequences of mismatches are regulated by the Addendum as follows:

- upon the occurrence of a Modification Mismatch Event, where the CM makes the same amendments to the related Client Transaction, the CM also has the right to determine the loss or costs (or gains) incurred; and
- upon the occurrence of a Modification Mismatch Event or a Modification Change Event where it is impossible or impracticable for the CM to modify or maintain the related the Client Transaction, the CM has to notify the client. The client is given an opportunity to transfer or offset the related Client Transaction. If such transfer or offset does not occur, the transaction terminates automatically

Transfers—offsetting transactions

The ability to change its service providers quickly is key for clients, including in clearing transactions. Under section 5 of the Addendum, a CM is obliged to take prompt action to facilitate any requested transfer of a Client Transaction and the relevant CM/CCP transaction to another CM of the relevant CCP, subject to the relevant Rule Set. The transfer will depend on there being no CCP default, no CM Trigger Event and no default under any further transfer conditions be specified under the Annex to the Addendum.

An alternative way for closing out the position is available where the client requests that the CM accepts for clearing an 'Offsetting Transaction' in respect of one or more specified client transactions. The terms of the Offsetting Transaction would be identical to those of the specified client transaction, except that the CM would take the opposite position to the position it has under the specified client transaction. The relating 'Offsetting Condition' which has to be satisfied requires that: (i) no early termination date in respect of the relevant specified client transaction has been designated or notified; (ii) the client must have satisfied any resulting collateral requirements; and (iii) the clearing of the Offsetting Transaction should not increase the aggregate exposure of the CM to the client in respect of all client transactions beyond any risk limits agreed between the CM and the client.

Defaults—client defaults

Generally, the procedure around client defaults under section 8(a) of the Addendum is similar to that under the existing OTC master agreement, but with cleared transactions, the CM also needs to manage the close-out of the corresponding transaction at the CCP in accordance with the rules of the relevant CCP (which will depend on the type of client account and the type of assets posted as collateral).

If the specified contractual agreement between CM and its client is the 1992 ISDA Master Agreement, the Addendum provides that the payment measure is always 'Loss' (ie, the more subjective payment measure usually used in bespoke transactions) and then borrows from the close-out provisions of a 2002 ISDA Master, as they provide greater flexibility for reflecting all termination costs. More specifically, section 8(a) of the Addendum stipulates that:

- If 'Market Quotation' is the elected payment measure, then following the designation of an Early Termination Date in respect of any client transactions (except upon a CM Trigger Event or a CCP default), the Addendum will deem that Market Quotation would not produce a commercially reasonable result and Loss will be the applicable payment measure in respect of client transactions.
- The Loss is then deemed to be equal to:
 - > the amount that would be determined as the 'Close-out Amount' (pursuant an ISDA 2002 Master Agreement)
 - > *plus*, if Loss is the applicable payment measure other than as a result of Market Quotation being deemed not to produce a commercially reasonable result—the Termination Currency Equivalent of the 'Unpaid Amounts' (as defined in an ISDA 2002 Master Agreement) owing to the CM
 - > *minus* the Termination Currency Equivalent of the Unpaid Amounts owing to the client
- To ensure the fairness of the determinations, sections 8(a)(iv) to (v) of the Addendum impose various obligations on the CM, such as:
 - > the duty to act in good faith and using commercially reasonable procedures in order to produce a commercially reasonable result
 - > the duty to assess the number and nature of the relevant client transactions and the then-prevailing conditions in the relevant markets in which quotations for 'Close-out Transactions' or 'Risk-hedging Transactions' could be sought, and
 - > that Close-out Transactions or Risk-hedging Transactions with CM affiliates may only be used if executed on an arm's length basis and at then-prevailing market prices

Defaults—CM defaults

The key term for a CM default under the Addendum is the 'CM Trigger Event' which will occur when: (i) the applicable CCP formally declares a default in respect of the CM or (ii) an event results in the automatic termination of all relevant CM/CCP Transactions.

Section 8(b) of the Addendum prescribes that in the event of a CM Trigger Event:

- each client transaction automatically terminates at the same time as the related CM/CCP Transaction is terminated (or transferred)
- the value of each terminated client transaction for the purposes of calculating the applicable termination amount will be equal to the relevant CM/CCP transaction value; and
- the client will have the right to calculate the termination amounts due

Defaults—CCP defaults

Section 8(c) of the Addendum deals with CCP defaults. The general principle is that the CM will pass through what it receives. Upon the occurrence of a CCP default:

- each client transaction will automatically terminate at the same time as the related CCP/CM Transaction
- the value of each terminated client transaction for the purposes of calculating the applicable termination amount will be equal to the relevant CCP/CM transaction value; and
- the termination amount is determined by the CM and notified to the client

Hierarchy of events

Under section 8(d):

- if client transactions are capable of being terminated due to: (i) illegality/impossibility, (ii) a client default, (iii) a CM defaults or (iv) a CCP default, then the section in respect of which a party first exercises any right to terminate client transaction will prevail, but
- if both a CM default and a CCP default occur, and if any order of priority is given in the relevant Rule Set, then that priority will apply

The Annex

The Annex to the Addendum permits further customisation of the clearing relationship. The key elections under the Annex are:

- the inclusion of further conditions to the transfer of positions in the absence of default—those provisions could ensure fast action for the benefit of the client, but will also permit the CM to set out its own requirements, such as payment of due amounts or no potential or actual defaults existing
- the grant of permission to the CM to re-use the collateral that the client posted to the CM, for on-posting to the CCP—the re-use would be the most cost-effective method for the CM, but it switches off the client asset protection that may otherwise apply to the posted assets; and
- the right to request termination (by either the CM or the client) in respect of CCP services identified in a written notice to the other party, in which case all client transactions relating to such notified CCP service will automatically terminate

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