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Briefing note June 2013

ISDA/FOA CLIENT CLEARED OTC DERIVATIVES ADDENDUM

ISDA and the FOA today published the Client Cleared OTC Derivatives Addendum. After a year of working group deliberations involving both buy- and sell-side firms, the Addendum is anticipated to become the market standard document for papering the client clearing relationship between clients and clearing members for clearing their OTC derivative transactions.

The Addendum aims to amend existing client documentation to allow for clearing of OTC derivatives in compliance with EMIR. It is a comprehensive document reflecting a negotiated compromise between those involved in its development. However, the result is not a document that parties just sign on the dotted line. The Addendum leaves a number of elections open for negotiation between client and clearing member. More importantly for those new to OTC derivatives clearing, users should ensure they understand the consequences for them, their cleared OTC derivatives portfolios and their collateral of entering into the Addendum and the legal and operational assumptions which underpin it.

Background

The clearing of OTC derivatives contracts through central counterparties ("**CCPs**") has been firmly on the industry's agenda since the world's leaders met at the G20 Summit in Pittsburgh back in 2009 and announced that all standardised OTC derivative contracts should, where appropriate, be cleared through CCPs. Fast forward to 2013 and industry participants are battling to implement the flood of regulatory changes, primarily driven in Europe by the requirements of (what is commonly referred to as) the European Markets and Infrastructure Regulation ("**EMIR**"). With the start date for mandatory clearing in Europe falling towards the back end of the implementation timetable, many market participants have been focusing on implementation of the more immediate requirements of EMIR. However, with mandatory clearing anticipated to be phased in from mid-2014, the clearing obligation will be featuring high on the EMIR implementation agenda going forward.

The challenge

Users of derivatives who find themselves subject to EMIR's clearing obligation will have three choices as to how to fulfil the obligation: become a member of an authorised or recognised CCP, become the client of a member of an authorised or recognised CCP or enter into indirect

At a glance

- The Addendum sits beside and forms a single agreement with existing OTC derivatives trading documentation
- The Addendum allows clearing through multiple CCPs under a single document
- Following clearing member or CCP default, the Addendum creates separate netting sets per CCP service
- Client's termination rights upon a clearing member default are very limited
- Client is given pre-default porting rights enabling client to switch clearing member prior to a clearing member default

clearing arrangements with the client of a clearing member of an authorised or recognised CCP. Direct CCP membership will not be an economic or practical option for any but the largest derivatives users. The mechanics of EMIR-compliant indirect clearing are some way from being rolled-out into the market, leaving the second option, known as "client clearing", as the most immediately viable option for many derivatives users subject to the clearing obligation.

One of the major problems for the market is how to document the complex clearing arrangements between "clients" (derivative users not direct members of a relevant CCP) and "clearing members" (direct members of a relevant CCP) in a way that will not result in an avalanche of paper for both client and clearing member, bearing in mind that clients with a diverse derivatives portfolio will need their clearing member to clear derivatives through multiple CCPs (as a particular CCP may not clear all types of derivatives).

The industry's response

Since May 2012 a cross section of buy- and sell-side firms have been meeting regularly in a joint ISDA and FOA working group to agree the terms of the ISDA/FOA Client Cleared OTC Derivatives Addendum (the "**Addendum**"). The Addendum is intended to be the market document for papering the OTC derivative clearing relationship between a client and its clearing member. Other forms of documentation already exist for client clearing. For example, a suite of client clearing documentation is currently in use by a limited number of clients and clearing members for the clearing of interest rate swaps through LCH.Clearnet's SwapClear service. The advantage of the Addendum over CCP-specific suites of documentation such as the SwapClear documentation is that the Addendum documents within a single agreement the clearing arrangements for the clearing of derivatives through multiple CCPs, so avoiding the need for multiple sets of documentation between the same client and the same clearing member.

The architecture of the Addendum

The Addendum has been designed to work alongside and form a single agreement with the existing documentation in place between the client and the clearing member, such as an ISDA Master Agreement or a set of futures and options terms based on the FOA's Professional Client Agreement. Bolting onto the underlying trading document, the Addendum will apply only to those transactions under that underlying trading document which are cleared by the clearing member through a CCP service specified in the Annex to the Addendum (the Annex is the negotiated portion of the Addendum (like the Schedule to an ISDA Master Agreement)) leaving all other transactions under the underlying trading document untouched by the Addendum.

Key features of the Addendum

Amidst the complex detail of the Addendum, there are some key features to note:

- *Netting Sets*

If cleared transactions are terminated early following either the clearing member being designated a defaulter by the CCP or the CCP itself defaulting, the early termination provisions of the underlying trading document still apply, but are supplemented by the Addendum. Most importantly, following a clearing member or CCP default the Addendum will create separate netting sets for each CCP service through which the client's trades are cleared, so the close-out netting provisions of the underlying trading document will apply to cleared transactions in sets according to which CCP the transactions are cleared through. The result is a separate close-out amount (or “Cleared Set Termination Amount”, to use the Addendum’s terminology) per CCP service.

In calculating a Cleared Set Termination Amount, the Addendum requires the use of the values given to the transactions featuring in the relevant netting set by the relevant CCP.

- *Valuation of transactions following a client default*

Although following a client default all cleared transactions under the Addendum across CCP services can be netted (no separate netting sets are required following a client default in contrast to a clearing member or CCP default), the Addendum adds an extra layer on top of the close-out netting provisions of the underlying trading document when it comes to the valuation of transactions which are terminated early. The Addendum allows the clearing member to take into account the cost of risk neutralising the back-to-back transactions between the clearing member and the CCP, but the clearing member’s discretion in doing so is tempered by some buy-side negotiated concessions which, to an extent, borrow from the position agreed between the buy- and sell-side in the corresponding US market document (the FIA-ISDA Cleared Derivatives Addendum). Firstly, the clearing member must always act in accordance with the “Close-out Standard”, requiring good faith and the use of commercially reasonable procedures in order to produce a commercially reasonable result. The Addendum goes to on contemplate a number of methods which the clearing member may use to risk neutralise its exposure to the client’s portfolio and requires commercial reasonableness on the part of the clearing member as to its use of such methods.

- *Disapplication of client's termination rights*

If a client and its clearing member document the clearing of their OTC derivatives under futures and options terms of business, then the client may or may not have termination rights against the clearing member in the underlying trading document. If the OTC trading relationship is documented under an ISDA Master Agreement, then the client is almost certain to have some termination rights against the clearing member. In relation to those cleared transactions covered by the Addendum, all termination rights that the client may have against the clearing member under the underlying trading document will be disapplied, including any bespoke termination rights which the client has negotiated into the underlying trading document. Instead, cleared transactions covered by the Addendum will terminate for a clearing member default only when the relevant CCP defaults the clearing member under the CCP rules or the transactions between the clearing member and CCP terminate automatically under the CCP rules. On first blush, this may seem like a one-sided position as the clearing member retains all of its termination rights against the client in the underlying trading document. The justification can be summarised as follows: the underlying trading document (particularly if that is an ISDA Master Agreement) is premised on the two parties to it being independent trading counterparties, whereas under a clearing relationship the clearing member is essentially offering a service to the client. The client does have exposure to the clearing member as cleared transactions are still entered into with the clearing member on a principal-to-principal basis, but the client protections offered by the CCP upon a clearing member default vastly reduce the client's credit risk to the clearing member, so the clearing member becomes akin to a "riskless principal". Consequently, the client does not need the termination rights provided in bilateral trading documentation, and indeed such termination rights could undermine the operation of the client protections offered by the CCP. For those clients who do not accept this position (and it is possible to debate the justification), they can try and negotiate a different position when agreeing the Addendum Annex with their clearing member, although, depending on their relative bargaining position, they may wish to focus on other mechanics provided by the Addendum to manage clearing member credit risk, primarily their pre-default porting rights.

- *Pre-default porting*

Although the client is stripped of its termination rights prior to the CCP defaulting the clearing member, the *quid pro quo* for the client is its pre-default porting rights. Pre-default porting requires the clearing member to co-operate with the client in transferring cleared transactions to an alternative clearing member appointed by the client, provided that a number of conditions are met (e.g. no outstanding defaults, fulfilling any resulting margin calls etc.). In reality, if the client is no longer comfortable with the clearing member's credit quality prior to the CCP defaulting the clearing member, then the client's remedy is to pre-default port its cleared transactions away to a replacement clearing member. Whilst this is a valuable remedy, the clearing member's obligation to co-operate is dependent on a number of conditions (some of which are open for negotiation between client and clearing member in the Annex to the Addendum) and, ultimately, it is not a self-help remedy. So if the clearing member fails to co-operate with the pre-default porting provisions in breach of the Addendum, then the client's remedy would be a claim against the clearing member for breach of contract.

- *Collateral*

If the underlying trading document is not an ISDA Master Agreement then the collateral provisions of the underlying trading document are assumed to be sufficiently flexible to deal with the complexities of cleared margin calls and will continue to apply. If the underlying trading document is an ISDA Master Agreement then any existing Credit Support Annex between the client and clearing member is disapplied and a bespoke Credit Support Annex will replace it. A separate Credit Support Annex will be deemed created for each CCP service to which the Addendum applies.

Nothing left to negotiate?

The Addendum is anticipated to become the market standard document for papering OTC derivative client clearing going forward. That is not to say that clients and clearing members will just sign on the dotted line. The pro forma Addendum leaves a number of matters for negotiation in the Addendum Annex. In addition, it is likely that clearing members will produce house-forms of Addendum reflecting the commercial and operational amendments to the standard form document required by the particular institution.

The challenges for client users of the Addendum are possibly greater. Clients should understand both the complex and, in some respects, highly negotiated, positions reflected in the Addendum and the operational and commercial assumptions which underlie those positions if they are to properly understand the deal that they are signing up to. Clients should also understand the client protections offered at the CCP level and how these flow through the Addendum.

Well advised users of the Addendum will spend time understanding its effect for them, their cleared OTC derivatives portfolio and their collateral.

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