EMIR – Gearing up for Clearing – PART III

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SLAUGHTER AND MAY
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Mandatory central clearing of OTC derivative transactions through central counterparties (CCPs) is now looking likely to begin for certain counterparties some time between June and September 2016, possibly sooner, according to implementing rules relating to the European Market Infrastructure Regulation (EU 648/2012) (EMIR) which have been adopted by the European Commission and which are now subject to a period of review and scrutiny by the European Parliament and Council of the European Union. Derivatives counterparties who have clearing obligations should consider the steps which they will have to take to comply with any clearing obligations to which they are subject and, in particular, whether it will be necessary for them to enter into client clearing arrangements with a clearing member (a CM) of a CCP in order to clear transactions subject to the clearing obligation. This briefing, the last in a three part series, is intended to provide an overview of some of the legal and practical aspects of client clearing which clients should consider, including the legal documentation (with a focus on the ISDA/FOA Client Cleared OTC Derivatives Addendum for use with English law governed transactions (the Addendum)).

This briefing follows on from our client briefings “EMIR – Gearing Up for Clearing – Part I”, which considered the clearing obligations imposed by EMIR, and “EMIR – Gearing Up for Clearing – Part II”, which gave an overview of the structure of client clearing, together with points for consideration when choosing a CM. This briefing also provides updates to our previous briefings in relation to the clearing of interest rate and credit derivatives and the various exemptions that may be available.

1. LEGAL ASPECTS OF CLIENT CLEARING

Bilateral OTC derivative transactions are usually documented by means of market standard agreements and confirmations, including those produced by the International Swaps and Derivatives Association, Inc. (ISDA), the structure and content of which counterparties are generally familiar with. However, since clients’ standard transaction documentation will make no provision for clearing and, in particular, the interposition of a CCP (and, for clients clearing through a CM, their CM as well) between the counterparties, clients wishing to clear derivatives transactions will need to enter into supplementary documentation to amend the terms of their bilateral transactions so that these are suitable for clearing.

As a result, clients will need to become familiar with the clearing documentation which will supplement their bilateral agreements in respect of cleared transactions. This documentation is complex and introduces a structure for client clearing which is quite distinct in character from the usual relationship between OTC derivatives counterparties. It raises a number of legal issues which are additional to, and different in nature from, those issues which parties negotiating a bilateral, uncleared transaction would expect to face. Clients will need to ensure that...
they are aware of these issues in order to be able to effectively negotiate client clearing arrangements which meet both their commercial needs and objectives and regulatory requirements which apply to them.

2. THE DOCUMENTATION STRUCTURE

The client clearing documentation governing the overarching legal relationship between a CM and a client (where the principal-to-principal clearing model is used) will generally consist of the following documentation:

A) a master agreement such as an ISDA Master Agreement (the non-clearing Master Agreement) which governs transactions (both cleared and uncleared) between a client and its CM;

B) an execution agreement or execution terms (sometimes referred to as a give-up agreement) between the client and its counterparty (who may also be the client’s CM). This governs the submission for clearing of transactions entered into by the parties which it is intended should be centrally cleared;

C) a clearing agreement between the client and its CM (the Clearing Agreement). This Clearing Agreement is based on the non-clearing Master Agreement, which is modified by the Addendum or other clearing documentation in respect of cleared transactions only. Uncleared transactions remain governed by the un-amended non-clearing Master Agreement. Where clients enter into transactions with a counterparty who is not their CM, it should be noted that it will be the non-clearing Master Agreement with the CM (not their master agreement with their counterparty) which will form the basis of the Clearing Agreement;

D) collateral arrangements in respect of cleared transactions (the Collateral Agreement). CMs will be required to post margin in the form of initial margin (IM) and variation margin (VM) to the CCP to cover the risk of CM default and market risk respectively and the client in turn will also be required to provide IM and VM to its CM; and

See “EMIR – Gearing Up for Clearing – Part II” for further details in relation to the margin requirements for client clearing.

E) ancillary documentation such as fee letters or documentation relating to operational arrangements. Some CCPs may require CMs to enter into additional documentation with their clients such as participation agreements.
3. EXECUTION ARRANGEMENTS

As a preliminary to clearing derivatives transactions, the parties will generally enter into execution terms or an execution agreement which govern(s) the submission of a transaction for clearing. ISDA and the Futures Industry Association (the FIA) have published a form of execution agreement, the ISDA/FIA Europe Cleared Derivatives Execution Agreement, which is designed to facilitate trading between an executing broker and its client of transactions intended by the parties to be centrally cleared using the principal-to-principal clearing model and which is intended to function across multiple CCPs (the Execution Agreement). There is also CCP-specific documentation which serves the same purpose, such as the SwapClear Execution Standard Terms produced by LCH.Clearnet.

For more details regarding the Execution Agreement produced by ISDA and the FIA, see “The Execution Agreement” in Annex 1.

4. THE CLEARING AGREEMENT

There is a range of clearing documentation which has been produced to document the Clearing Agreement between CMs and clients. This includes industry-led documentation such as the Addendum and also the FOA Clearing Module (produced by the Futures and Options Association (FOA) and, unlike the Addendum, aimed primarily at exchange-traded derivatives rather than OTC derivatives), together with CCP-specific agreements, such as the Swapclear client clearing documentation produced by LCH.Clearnet.

One of the Addendum’s main advantages is that it is designed to be used across multiple CCPs and is coming to be recognised as the market standard template for documenting the client clearing relationship. It is intended to be used in conjunction with the ISDA Master Agreement (or FOA Futures and Options Agreement) as the non-clearing Master Agreement. It aims to amend and supplement the existing non-clearing Master Agreement between the
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Clients should note that many provisions of the Addendum are designed to protect the CM. This is because the Addendum is designed to reflect, to a large extent, the “riskless principal” approach which CMs negotiating Clearing Agreements seek to take. As CMs view themselves as being “service providers” enabling clients to access CCP clearing services for relatively modest fees, they seek to ensure that they are protected as far as possible from any mismatch between their cleared transactions with the client (client transactions) and the corresponding cleared transactions between the CCP and the CM (CM/CCP transactions), as well as any other risks or costs which they might incur as a result of providing clearing services. This informs many aspects of the Addendum (as discussed in further detail below and in “Key provisions in the Addendum and Collateral Agreement” in Annex 2). However, it is important to remember that the Addendum is a template document only and leaves a number of elections open for negotiation with CMs. Clients and CMs may also choose to make further amendments. Therefore, rather than a finished product, the Addendum should be regarded as a framework for bilateral negotiation which can be tailored to the parties’ specific requirements (although there are certain key provisions which CMs are reluctant to amend – see “Key provisions in the Addendum and Collateral Agreement” in Annex 2 for more details). Clients should note that many CMs will make further amendments in their own standard template based on the Addendum to further improve their position.

The Addendum adopts the usual ISDA documentation structure, with any elections and amendments made in an annex to the Addendum (the Addendum Annex) and the Addendum itself left unaltered. The Clearing Agreement will govern all cleared transactions between the parties, while non-cleared transactions will continue to be governed by the non-clearing ISDA Master Agreement.

See “Key provisions in the Addendum and Collateral Agreement” in Annex 2 for more detail in relation to specific provisions of the Addendum.

5. MARGIN AND THE COLLATERAL AGREEMENT

Margining is the most important method used by CCPs to cover the market risks and potential close-out costs in relation to the transactions which they clear. CMs are therefore required to post margin to the CCP in respect of cleared transactions (both initial margin (IM) to cover the risk of CM default and variation margin (VM) to cover market risk) and are subject to daily and potentially intra-day margin calls from the CCP. VM is calculated daily by mark-to-market and passed via the CCP from one CM to another. IM is reviewed more periodically. CMs who are clearing client transactions will require clients to transfer IM and VM to them to allow them to meet their margin obligations to the CCP in respect of the relevant client transactions.

Where a CM enters into a Clearing Agreement with a client, it will also enter into an associated Collateral Agreement. Under the terms of the Addendum, the Clearing Agreement deemed to be created by the Addendum does not incorporate the parties’ existing Credit Support Annex or Credit Support Documents (if any) in relation to the non-clearing ISDA Master Agreement, but instead, if an election is made that “Collateral Standard Terms” should apply in the Addendum Annex, incorporates a Credit Support Annex (CSA) with a bespoke form of Paragraph 11 specifically drafted by ISDA for use in relation to cleared transactions. This CSA constitutes the Collateral Agreement for the purpose of the Clearing Agreement. The amendments to the CSA in the bespoke
Paragraph 11 are intended in part to align the collateral requirements in relation to the client to those of the CM to the CP to allow the CM to satisfy its obligations to the CCP. However, clients should note that there will often be differences between their obligations to their CM and their CM’s obligations to the CCP. For instance, some CMs will allow clients to transfer collateral on a daily basis only, without having to meet intra-day calls, while CMs will generally have to meet both daily and intra-day calls by the CCP. The corollary of this is that CMs will often impose additional collateral requirements over and above those of the CCP to provide a “collateral buffer” and ensure that they are covered in respect of intra-day calls by the CCP in relation to the client’s transactions.

See “Key provisions in the Addendum and Collateral Agreement” in Annex 2 for more detail in relation to collateral arrangements.

6. KEY FEATURES OF THE ADDENDUM

There are a number of features in respect of the clearing relationship created by the Addendum which clients may initially find surprising and which contrast with the nature of the bilateral and often more even-handed relationship which clients will usually have with their derivatives counterparties. In particular, there are certain general risks for the client which are inherent in the client clearing structure and consequently exist in most Clearing Agreements. Many of these risks are a consequence of the “riskless principal” approach described in section 4 above. These risks include:

A) Lack of mutuality/one-sided nature of Clearing Agreements

Although the amended Master Agreement created by the Clearing Agreement will be based on the existing non-clearing Master Agreement between the parties, the Addendum amends this so that the client has no ability to terminate cleared transactions unless there is a default by the CM and the CM is declared a defaulter by the CCP. Therefore, if a client’s CM defaults on any other basis under the amended Master Agreement, the client’s remedies are likely to be limited and the client may find itself obliged to continue performing its own obligations to a CM in respect of which an event of default or termination event has occurred. A client would generally not, for instance, even have the right to plead force majeure (although a client might have the right to terminate for Illegality/Impossibility if it was elected in the Addendum Annex that this should apply). Clients should note that this disapplication of Events of Default and Termination Events under the Clearing Agreement is one-sided as the CM retains all its usual rights of termination.

See paragraphs (J) (Illegality/Impossibility (Section 7)) and (K) (Early termination following default by client, CM or CCP (Section 8) or in circumstances other than default (Section 9)) in section 1 of Annex 2 for more information in relation to the one-sided nature of the termination provisions in the Addendum.

B) Loss mutualisation/limited recourse/indemnity

If the CCP suffers losses (e.g. due to default by a CM), it is possible that, despite the segregation requirements under EMIR, a proportion of these losses may be passed on to the clients of CMs. The Addendum, for instance, contains a limited recourse provision, the effect of which is to make the CM’s obligations to its
clients dependent upon actual performance or payment by the CCP in relation to the corresponding CM/CCP transactions or any collateral arrangements. The Addendum also contains widely drafted limitation of liability and indemnity provisions which, for instance, require the client to indemnify the CM in relation to the occurrence of a CCP default. Although these are elective provisions and so can be disappplied, most CMs will require these provisions to apply (though there may be some discussion over scope).

See paragraphs (L) (Limitation of Liability/Indemnity (Sections 12 and 13)) and (M) (Limited Recourse (Section 15)) in section 1 of Annex 2 for more information on these client risks.

C) Market disruption, increased costs and/or withholding

To the extent that a CCP or CM suffers a loss as a result of a disruption in the market, increased costs or any withholding tax, that loss may be passed on to clients. The Addendum, for instance, contains an elective “Increased Costs” provision which, if it is specified that this should apply, provides for the increased costs specified in the Addendum Annex to be passed on to the client.

See paragraphs (N) (Increased Costs (Section 16)) and (H)(Tax provisions (Section 4 and Addendum Tax Provisions)) in section 1 of Annex 2 for more information.

D) Changes to corresponding CCP transaction or CCP Rule Set

Clients should note that, under most clearing documentation structures including the Addendum, changes to the corresponding CM-CCP transaction may be automatically passed through to the CM-client transaction or, if this is not possible, CMs may have the right to unilaterally amend the terms of the client transaction if a mismatch arises with the corresponding CM-CCP transaction. If it is "impossible or impracticable" for a transaction to be maintained due to a change to the CM-CCP transaction or a mismatch with the CM-CCP transaction, the Addendum gives the CM the right the terminate the relevant CM-client transaction. The meaning of "impracticable" in this context is unclear, and so it may prove difficult for a client to challenge termination by a CM on this basis which gives the CM a wide degree of discretion.

Changes to the CCP’s rules and procedures will also generally be passed through automatically to the client’s transactions, or the client required to comply with them without notice)

See paragraphs (C) (Modification Events (Section 3(c)) and (E) (CCP Rule Set (Sections 3(e) and (f)) in section 1 of Annex 2 for more information in relation to changes to client transactions.

E) Conditionality on porting

One key protection for clients under Clearing Agreements, which is supposed to compensate for the disapplication of clients’ termination rights, is the ability to port transactions to an alternative CM. However, this requires the client to have a back-up CM in place and to meet any transfer conditions in its Clearing Agreement. It will also have to meet any conditions which its back-up CM imposes for accepting the transaction and there is no guarantee that, even if these conditions are satisfied, the back-up CM will accept transactions as it will usually have discretion as to whether to do so. Particularly if there is extreme stress within
the financial system (which might be precisely the circumstance in which a client wishes to port), a CM may be unwilling to accept new transactions. Therefore, porting is not a straightforward solution if a client is unhappy with its CM and will require both the cooperation of the existing CM and the back-up CM.

See paragraph (I) (Pre-default porting and Transfer Conditions (Section 5)) in section 1 of Annex 2 for more information about restrictions on porting.

7. PRACTICAL AND OPERATIONAL CONSIDERATIONS IN RELATION TO CLIENT CLEARING

In addition to legal issues in respect of client clearing arrangements, there are also certain important practical and operational considerations for clients to consider if they are contemplating entering into Clearing Agreements with CMs.

7.1 “On-boarding”

In order to become a client of a CM, clients will have to go through an “on-boarding” process. This will include agreeing fees and legal documentation, as well as completing KYC. In addition to this, gearing up for clearing will also involve a number of operational aspects such as setting up client accounts and testing the account set-up and the processes. The CM is likely to require extensive information and documentation from the client in order to complete this process, so clients should ensure that they leave sufficient time to complete the on-boarding process before their legal obligations under EMIR come into effect or they need to start clearing for other reasons. In addition, as the deadline for compulsory central clearing draws nearer, CMs may need to on-board large volumes of clients in a short time period which may lead to administrative delays or unwillingness on the part of CMs to commit resources to the negotiations necessary to make clearing arrangements workable for particular clients. Clients who do not leave sufficient time to negotiate their Clearing Agreements may have to accept the CMs’ standard documentation regardless of the workability of the documents for their business or other important considerations. Furthermore, clients should consider contingency plans in case it is not possible to implement clearing arrangements within the required timeframe, such as entering into exchange traded derivatives contracts or restructuring their financing.

7.2 Transaction limits

Although not provided for in the standard form Addendum, many CMs will specify transaction or trading limits which apply to clients in the Addendum Annex. These are intended to limit the risk exposure, size or concentration of the positions which the CM will accept on behalf of its clients. Where the CM specifies such limits, these should be clearly defined so that the client is able to comply with them. CMs will generally attempt to reserve the right to unilaterally amend trading limits. If this is accepted, clients should try to ensure that a reasonable notice period is agreed for any reductions to the applicable limits. In addition, to avoid having to close out or port existing transactions, CMs should be asked to limit any reductions in limits to transactions entered into subsequently and to exclude existing trades. Where this is not possible, a similar notice period to that for CM termination of agreed CCP services should be included in order to recognise that the CM’s ability to terminate existing transactions may amount to a de facto termination right.
7.3 Margining/collateral management

Clients should note that, besides the risk implications and substantially higher costs associated with posting IM and VM, their Collateral Agreement with their CM is likely to require them to provide margin on a daily or intra-day basis. There are two aspects of margining which it is important for clients to consider. The first is the administrative or logistical aspect. Margin calls will generally be made by email or over the phone on a daily or intra-day basis and clients will have to transfer margin to meet margin calls by the end of the same day (unlike under their current non-clearing Master Agreement, which, where margin is required, will not generally require margin to be transferred on a same-day basis). Clients should therefore ensure when negotiating Clearing Agreements that they have a clear understanding of the logistical arrangements and how these will work. By way of example, if the Notification Time for transfers of margin is 4.00pm UK time, clients, especially those located in time zones ahead of the UK, should consider whether it is feasible for their operational teams to carry out same-day margin transfers if they only receive notice by this time or whether they should negotiate an earlier notification time, a short term liquidity facility or an operational buffer with their CM.

The second aspect of margining to consider is the availability of acceptable collateral. To ensure they can meet margin calls, clients who do not typically hold high-quality, liquid assets may need to hold additional cash or have access to credit lines in order to ensure that they have acceptable collateral available to meet margin calls by their CM.

7.4 Operational processes

Clients will need a certain amount of infrastructure in place in order to be able to clear transactions. At the very least, clients will need access, either directly or through a service provider, to an electronic platform to match the transaction data submitted by the client and its counterparty and to communicate that data to the relevant CCP.

7.5 Netting

This is a complicated area and one in which there are likely to be further developments, but clients should give some thought to the impact which clearing their derivative transactions through CCPs will have on their netting arrangements. The ISDA Master Agreement, for instance, allows for netting of derivative receivables and payables in respect of a particular counterparty. For clients clearing through CCPs, their counterparty in this case will be the CM and not the original counterparty, assuming the original counterparty is a different entity to the CM. Although a key incentive for clearing OTC derivative transactions through CCPs is meant to be higher multilateral netting, the existence of multiple CCPs which are not linked and the fact that CCPs presently offer multilateral netting only within asset classes are likely to reduce the benefits offered by netting, in particular, the reduction in margin requirements through netting. In addition, if some derivative transactions with certain counterparties are cleared centrally and some are not, this has the potential to lead to “netting fragmentation” as there will be no netting between cleared and non-cleared contracts. Therefore, clients should be aware that netting in the “cleared world” is likely to be very different from netting under their existing master agreements and should not rely on being able to reduce their collateral requirements or exposures in all cases through netting. While cross-product and cross-CCP netting are being discussed, neither is currently in contemplation.
8. GEARING UP FOR CLEARING – DOCUMENTING THE CLEARING RELATIONSHIP

Clients who need to enter into Clearing Agreements with CMs should bear in mind that, despite the “riskless principal approach”, there are a number of aspects of the documentation which are open to discussion. Given that some of the obligations imposed by Clearing Agreements may prove relatively onerous for clients to comply with, clients need to familiarise themselves with the structure and substance of the clearing documentation to ensure that they negotiate arrangements which are suitable for their commercial needs and objectives. In particular, there are a number of legal and practical aspects which should be considered, especially in relation to the collateral arrangements, to ensure that any clearing arrangements entered into with a CM are workable for the client.
Annex 1
The Execution Agreement

There are a number of hoops to jump through before a transaction between a client and its counterparty (or executing broker (EB)) becomes a cleared transaction. The first step is to enter into a non-cleared OTC derivative transaction in the usual way.

The process by which that transaction is cleared is set out in the execution terms or execution agreement between the client and its EB. The Execution Agreement produced by ISDA and the FIA is designed as a template for parties to use when negotiating execution arrangements for English law governed swap transactions which are intended to be cleared. Like the Addendum, it is meant to be a "CCP-agnostic" document which can be used across CCPs.

The Execution Agreement sets out the rights and obligations of the client and EB to a trade that is intended to be cleared and the process for submitting a transaction to a CCP, including time limits within which a transaction must be accepted for clearing by the parties' CMs (if they are clearing through a CM) and by the CCP. There must be agreement between the parties as to the relevant CCP and the relevant electronic system for submission to a CCP of a transaction for clearing. Once a transaction is accepted for clearing, the Execution Agreement provides that the original transaction between the client and its EB is replaced by two separate cleared transactions between the parties' CMs and the relevant CCP (CM/CCP transactions). Where parties are clearing through a CM, corresponding client transactions will arise under the terms of the Clearing Agreement between the client and its CM.

As well as setting out the process for clearing, the Execution Agreement addresses potential execution issues which might arise if a transaction fails to clear. There is an obligation on the parties to take "reasonable steps" to enable a transaction to be cleared. If it is not accepted for clearing, the parties can either elect to treat the transaction as a bilateral transaction (assuming it is not subject to the compulsory clearing obligation under EMIR and subject to agreeing any necessary modifications or amendments) or to terminate the transaction. If a transaction is terminated, the early termination amount is determined in accordance with the usual 2002 ISDA Master Agreement close-out mechanisms.

Similarly to the Addendum, clients should remember that the Execution Agreement is a template only and should be amended to meet the parties' requirements. The parties can negotiate to amend the terms of the Execution Agreement as necessary in the annex to the Execution Agreement (the Annex). The Annex, for instance, requires the parties to make certain elections. For example, elections which the parties might choose to make in the Annex include the application of "Termination Long Stop", which means that a transaction will terminate after a certain period if there is a "Relevant Event" which prevents it from being cleared within a certain period. Similarly, the parties can also make bespoke amendments to the Execution Agreement in the Annex, including, for instance, changing the time periods within which trades must be submitted for or accepted for clearing.
Annex 2
Key provisions in the Addendum and Collateral Agreement

The Addendum is a complicated document and it is important that clients negotiating the Addendum with prospective CMs are familiar with the key provisions in the Addendum and related Collateral Agreement. The following are some of the key issues which clients may wish to consider in relation to particular Addendum provisions.

1. THE ADDENDUM

Key provisions in the Addendum include the following:

A) Representations (Section 2)

The Addendum provides that each party repeats the representations it gives in the non-Clearing ISDA Master Agreement on the date on which the Addendum, or any amendment to the Addendum, is entered into. The representations are also repeated by the client when it submits a transaction for clearing and by the CM when it clears a transaction. The Addendum contains specific provisions regarding tax representations, including scope for new CM and client tax representations to be included in the Clearing Agreement.

The Addendum contains specific provisions regarding tax representations. If there are client tax representations and these are not (or cease to be) accurate, the client is obliged to notify the CM and provide alternative client tax representations and related tax documents, which are then deemed to be included in the Clearing Agreement. A corresponding obligation is imposed on the CM.

B) Client transactions (Section 3(a) and (b))

Under the Addendum, client transactions arise automatically on the related CM/CCP transaction being cleared through a CCP or transferred from another CM (due to, for instance, pre-default porting of transactions away from that CM). The terms of each client transaction are identical to the terms of the related CM/CCP transaction, except as modified by the Clearing Agreement and the collateral arrangements. The CM takes the opposite position under the client transaction to the one it has under the related CM/CCP transaction.

C) Modification Events (Section 3(c))

A feature of the “riskless principal” approach, the Addendum contains provisions which apply if there is any event in relation to, or any action or omission by, a CCP in relation to a CM/CCP transaction (subject to certain exceptions such as CCP or CM default which are already addressed in the Addendum) (a Modification
**Trigger Event** which amends the economic terms of the rights, obligations, liabilities or exposure amounts of the CM or the CCP under the relevant CM/CCP transaction (a **Modification Event**). Clients should note that Modification Trigger Events include changes in applicable law (including tax laws) and actions taken by any governmental authority (including a tax authority).

In some circumstances, a corresponding modification is made automatically following a Modification Event in accordance with the CCP Rule Set to the relevant client transaction which removes the mismatch (referred to as a **Modification Change Event**). If the CCP Rule Set does not provide for a modification to be made automatically and a mismatch remains following the Modification Event (a **Modification Mismatch Event**), the CM can make the same modifications as have been made to the CM/CCP transaction in order to remove the mismatch. The overall effect of this is to allow for changes to be made to client transactions, either automatically or by the CM, without the client’s consent or acknowledgment being required (although the CM is required to give notice of any modification it makes pursuant to a Modification Mismatch Event to the client as soon as reasonably practicable).

If, following a Modification Mismatch Event or a Modification Change Event, it is "impossible or impracticable" for a client transaction to be maintained by the CM, the transaction may be terminated by the CM. The Addendum provides for a notice period which is specified by the parties in the Addendum Annex (the **Modification Termination Period**); clients should note that, depending on what Modification Termination Period is specified, it may be possible for CMs to terminate transactions without clients’ consent on very short notice if they take the view that it is "impossible or impracticable" to maintain a transaction.

Following a Modification Mismatch Event, a "Modification Loss Amount" may be payable if any loss or cost is incurred in relation to any modifications to the transaction. This amount is determined by the CM (acting in good faith and in a commercially reasonable manner).

Section 3(c) of the Addendum allows a wide scope for modifications or termination by the CM upon the occurrence of a Modification Event. Given that the meaning of “impracticable” in particular is unclear and that this may be a relatively low standard, clients may wish to require the removal of the CM’s right to terminate where it is “impracticable” to maintain the transaction and limit this right to cases of impossibility. Clients may wish also to have the right to terminate if a modification means that it is impossible or impracticable for the transaction to be maintained by the client (although it should be noted that, if clients do have such a termination right, close-out would, in accordance with Section 9 of the Addendum, be determined on the CM’s side of the market as if the client were in default – see paragraph (K) (Early termination following default by client, CM or CCP (Section 8) or in circumstances other than default (Section 9)) below). Although clients may be able to clear an offsetting transaction in these circumstances (and the Addendum requires CMs to clear offsetting transactions subject to certain conditions), this may not be as useful as having a termination right, especially if the same circumstance which makes it impossible or impracticable for the client to maintain a transaction would also apply to the offsetting transaction.

Other protections which clients should consider requesting are an appropriate notice period before modifications take effect as well as an appropriate Modification Termination Period.
D) Compression/Offsetting transactions (Sections 3(d) and 6)

The Addendum provides that clients may request that their CM compresses two or more CM/CCP transactions, or clears offsetting transactions. CMs are obliged to compress transactions on a written request from the relevant client and are also obliged to clear offsetting transactions provided that the “Offsetting Conditions” are satisfied. The Offsetting Conditions are that no early termination date has been designated in respect of the relevant client transaction, that the client has satisfied any condition agreed for this purpose in any portfolio margaining arrangement between the CM and the client and that the clearing of the offsetting transaction will not increase the CM’s aggregate exposure to the client in respect of all client transactions beyond any agreed risk limits (see section 7.2 (Transaction Limits) of this briefing). It is possible that CMs may try to include additional Offsetting Conditions in the Addendum (for instance, that there is no event of default or termination event under the Clearing Agreement or that this will not lead to an increase in margin required). If so, clients should review these carefully to ensure that their right to require CMs to clear offsetting transactions is not unduly restricted.

E) CCP Rule Set (Sections 3(e) and (f))

Although not in a direct contractual relationship with the CCP, clients will find themselves bound to a large degree by the CCP Rule Set. The terms of the Addendum provide that the client agrees to be bound by, comply and use “commercially reasonable efforts” to facilitate compliance by the CM with the “Core Provisions” of the relevant CCP (to the extent that such Core Provisions require the client or CM to be bound by, comply or facilitate compliance with such Core Provisions). The “Core Provisions” are those specified in Table A of the Addendum Annex (at paragraph 4) or, if nothing is specified, those provisions in the CCP Rule Set which relate to client transactions, including provisions establishing the basis for client transactions and the consequences for the client if the CM is declared a defaulter by the CCP. These will usually include, for instance, the CCP’s limited liability and indemnity provisions, the limited recourse provisions, the rules regarding CCP insolvency, the governing law provisions, the arbitration provisions and provisions relating to proceedings against the CCP or CM, and provisions relating to the suspension and termination of membership of CMs. Given the width of the fallback position, clients should ensure that something is specified in Table A to prevent this applying; either “Core Provisions” should be disappplied by specifying that none or applicable or, if a CM is unwilling to accept this, it should be limited to specified provisions.

In addition, the Addendum also provides that the client is bound by and must comply with the “Mandatory CCP Provisions” of the relevant CCP. “Mandatory CCP Provisions” are provisions which CMs are required by the CCP Rule Set to include in their clearing arrangements with clients; the Mandatory CCP Provisions prevail if there is any conflict between these terms and the terms of the Clearing Agreement between the CM and client. Like the Core Provisions, the Mandatory CCP Provisions are specified in the Addendum Annex in Table A at paragraph 4.

Clients also undertake not to take any action which would reasonably be expected to cause a breach of the CCP Rule Set by their CM and to take reasonable steps where their cooperation is needed to assist the CM in complying with the CCP Rule Set. This provision is very wide and clients should note that it includes rules which
a CM has to comply with in relation to a client, which then of itself requires the client to comply or to facilitate compliance by the CM rather than simply the CM having to procure that the client comply.

Furthermore, CCP Rule Sets may contain wide indemnities, including provisions requiring the client to indemnify the CM or the CCP for certain tax losses; by way of example, clients are referred to Rule 301 of ICE Clear Europe Clearing Rules dated 1 December 2014 and clause 9 of Exhibit 1 (Customer-CM CDS Transactions Standard Terms) to those Rules, which are respectively a Core Provision and a Mandatory Provision for CDS clearing through ICE Clear Europe Limited according to the standard form Table A in the Clearing Agreement.

F) No obligation to consent to clearing (Section 3(g))

Clients should note that the Addendum expressly states that there is no obligation on CMs to accept transactions for clearing (with the exception of offsetting transactions or compressed transactions – see above at paragraph (D) (Compression / offsetting transactions (Sections 3 (d) and 6)). Therefore, clients should be aware that, even though they may have a Clearing Agreement with a CM, this does not necessarily mean that they will always be able to clear transactions with that CM. Consequently, it will usually be sensible for clients to negotiate Clearing Agreements with more than one CM.

See “EMIR – Gearing Up for Clearing – Part II” for further details in relation to choosing a CM, including the advisability of maintaining arrangements with more than one CM.

It would be desirable for clients to negotiate a “soft” commitment to clear from the CM (for instance, to use “best endeavours” or make a good faith attempt to accept transactions for clearing). Some CMs have shown a reluctance to accept an absolute commitment to clear in case they lack operational capability to clear a particular transaction or wish to limit their exposure to a particular client. It will be interesting to see how this area develops further.

G) Payment Netting (Section 3(h))

“Payment Netting” is an elective provision under the Addendum. If it applies, transactions in the same currency on the same date are netted. Whether Payment Netting will apply is likely to depend on the operational capabilities of the CM and client. Payment Netting is limited to “Specified Netting Contracts” and CMs and clients can limit payment netting to selected transactions by appropriately defining “Specified Netting Contracts” in the Addendum Annex.

(H) Tax provisions (Section 4 and Addendum Tax Provisions)

The provisions relating to tax in the non-clearing Master Agreement do not apply to client transactions and CM/CCP transactions. Instead, the "Addendum Tax Provisions" which are set out in Appendix 3 to the Addendum apply. Some CMs then include additional tax provisions in the Addendum Annex.

Tax Deductions under client transactions (paragraphs 3, 4, 5 and 7)
Clients represent that, on the basis of the CM tax representations, they do not expect to be obliged to make any deduction or withholding for or on account of tax (a **Tax Deduction**). If that expectation changes, clients are obliged to use commercially reasonable efforts to notify the CM. A corresponding obligation is imposed on the CM.

All payments made under client transactions are to be made free from any Tax Deductions, unless such deductions or withholdings are required by law. If they are required, only the client is obliged to gross up. It should be noted that where the CM is to make a corresponding payment to a CCP, the client’s gross-up obligation extends to Tax Deductions in relation to the payment made by the client to the CM as well as Tax Deductions in relation to the payment made by the CM to the CCP. While there are a limited number of exclusions from the client’s gross-up obligations, the application of any such exclusion (other than the exclusion for non-compliance by the CM with certain of its obligations under the Addendum) would lead to the occurrence of a Tax Event, as discussed further below.

Clients should note that the Addendum Tax Provisions do not provide for any reimbursement of the client where the client’s gross-up obligation applies and the CM receives any repayment of, or utilises any relief in respect of, tax by reason of the Tax Deduction made by the client. However, CMs may (and should) be willing to add a tax credit clause if requested by the client.

Clients should also note that they may be required to indemnify the CM against any loss suffered where the CM should have made, but did not make, a Tax Deduction in respect of a payment under a client transaction.

**Tax Deductions under CM/CCP transactions (paragraphs 6 and 8)**

Where a CCP makes a Tax Deduction in respect of a payment under a CCP/CM transaction, the CM will only pay the reduced amount to the client unless that Tax Deduction is made by reason of circumstances corresponding to the exclusion for non-compliance referred to above (most of which would lead to the occurrence of a Tax Event as discussed further below). Clients may also be obliged to indemnify the CM against any loss suffered because a Tax Deduction should have been made in respect of a payment under a CM/CCP transaction, but was not made.

**Tax information (paragraphs 9 and 10)**

The client and the CM undertake to provide to each other, and the CM undertakes to provide to the CCP, such tax documents as may be required or reasonably requested in order that payments can be made without Tax Deductions.

**Other Taxes (paragraph 11)**

Clients are further required to bear and indemnify the CM and, if so required under the relevant CCP Rule Set, the CCP against all stamp, value added and other transaction taxes (together, defined as "Other Tax") levied in respect of a client or a CM/CCP transaction. While it is unlikely that a CM would accept a change to this
provision, clients may wish to propose a narrowing of the definition of “Other Tax” to exclude taxes otherwise compensated for under the Addendum Tax Provisions.

Tax Events (paragraph 12)

If a Tax Event occurs, the CM has the right to terminate the affected client transaction unless the client either agrees to gross up the CM for any Tax Deduction resulting from such Tax Event or waives its right to be grossed up. If the CM exercises its right to terminate the affected client transaction, the consequences are determined in accordance with the Clearing Agreement as if the client were in default (see paragraph (K) (Early termination following default by client, CM or CCP (Section 8) or in circumstances other default (Section 9) below).

Collateral (paragraph 14)

For the purpose of the Addendum Tax Provisions, payments made in respect of collateral provided in respect of a client transaction or a CM/CCP transaction are treated as payments under such a transaction.

CCP Rule Set (paragraph 15)

In so far as the Addendum Tax Provisions in respect of CM/CCP transactions conflict with the CCP Rule Set, the latter prevails. The Addendum Tax Provisions do not affect in any way the application of the CCP Rule Set to payments made to, or received by, a CCP under a CM/CCP transaction. (As to the CCP Rule Set generally, see paragraph (E) (CCP Rule Set above.)

I) Pre-default porting and Transfer Conditions (Section 5)

“Porting” refers to the transfer of client positions and associated margin from one CM to another CM. Pre-default (or “business as usual”) porting occurs where the original CM has not been declared in default by the CCP (as opposed to post-default porting, which is effected by the CCP where the original CM is in default according to the CCP’s rules and procedures). Due to the substantial disapplication of the client’s termination rights in cleared transactions (see below at paragraph (K) (Early termination following default by client, CM or CCP (Section 8) or in circumstances other than default (Section 9)), pre-default porting is the main protection for the client if it is dissatisfied with its relationship with its CM for any reason.

While the Addendum provides for pre-default porting, clients should note that there is no immediate, automatic right to port transactions and certain conditions will have to be satisfied in order for clients to be entitled to exercise their porting rights. The standard conditions for porting in the Addendum are that no CCP default or CM “trigger event” (essentially, the CM being declared a defaulter by the CCP) has occurred and is continuing (in which case pre-default porting is not permitted and the CCP’s rules and procedures will apply instead), and (ii) the client has transferred additional collateral to satisfy any additional collateral requirements which will result in relation to any transactions which remain with the original CM and are not transferred to the back-up CM. In addition, CMs may specify “Additional Transfer Conditions” in the Addendum Annex which clients must meet in addition to the standard conditions for transfer in the Addendum (such as all fees due and payable having been paid). The Addendum also provides for CMs to specify “Transfer Condition Default” provisions which will prevent the client from being able
to port (for instance, if there is an event of default or termination event on the part of the client in relation to the Clearing Agreement). Clients should review Additional Transfer Conditions and Transfer Condition Default provisions carefully to ensure that these do not unduly restrict their ability to port transactions. In particular, it is important to ensure that porting is not at the CM’s discretion (either through giving the CM a veto on porting or by allowing the CM in its absolute discretion to decide whether the conditions for porting have been met). This is because pre-default porting rights are likely to be most useful to clients in a scenario where their relationship with their CM is deteriorating or where they are looking to limit their exposure to a particular CM for any reason.

J) Illegality/Impossibility (Section 7)

"Illegality/Impossibility" is an elective provision in the Addendum and, if applied, gives the parties a wider right to terminate than they would usually have under the Illegality or Force Majeure provisions in the non-clearing Master Agreement (if an ISDA Master Agreement). In particular, it allows termination if it becomes unlawful, impossible or impracticable for a party to perform its obligations (except where caused by the client or CM as applicable) despite the heading suggesting that the termination right is limited to illegality/impossibility. Clients should note that, while it is true that this election gives a right to terminate where otherwise the client would have no right (since all other termination rights are disapplied in respect of the client under the Addendum, any termination would be in accordance with Section 9 of the Addendum and on the CM’s side of the market as if the client was in default (see paragraph (L) (Early termination following default by client, CM or CCP (Section 8) or in circumstances other than default (Section 9)) below). Therefore, one important effect of this section is that the CM now has an additional, wider termination right than it would have under the existing non-clearing Master Agreement which, if it exercises it, allows close-out as if the client were in default.

A preferable position for clients would be to limit the disapplication of termination rights in respect of the client under the non-clearing Master Agreement so that a client could still rely on "Illegality" and "Force Majeure Event" in the case of a 2002 ISDA Master Agreement or "Illegality" in the case of a 1992 ISDA Master Agreement to terminate in accordance with that agreement. It should be noted that CMs retain all their usual termination rights under the non-clearing Master Agreement in any event, so CMs do not necessarily need "Illegality/Impossibility" in the Addendum to terminate; this is simply a wider and more favourable termination right.

If "Illegality/Impossibility" is not applied and the disapplication of the client’s termination rights is not limited in any way, the client would have no right to termination if it should become unlawful or impossible to perform. Instead, the client would be in default if unable to perform its obligations in these circumstances. The CM would have its usual rights upon an event of default by the client under the non-clearing Master Agreement, including to designate an early termination date in respect of all outstanding transactions under the Clearing Agreement and to close out on its side of the market.

K) Early termination following default by client, CM or CCP (Section 8) or in circumstances other than default (Section 9)

One feature of the client clearing structure which presents additional risk for clients and which is very different from bilateral transactions is the one-sided disapplication of the client’s termination rights in relation to cleared transactions. Clients should note that the Addendum also provides for the disapplication of any provision of the
non-clearing ISDA Master Agreement which would entitle the client to withhold any payment or delivery as a result of a potential event of default, event of default or termination event on the part of the CM. Again, this is a one-sided disapplication as the CM retains the protection of Section 2(a)(iii) of the ISDA Master Agreement.

Should the CM default under the Clearing Agreement, the client will have no unilateral right to close out cleared transactions and the protection given to the client by Section 2(a)(iii) of the non-clearing ISDA Master Agreement will not be available for cleared transactions. Client transactions will terminate only upon the termination of the corresponding CM/CCP transactions. As Section 2(a)(iii) is disappplied in relation to the client, the client will remain subject to an obligation to make payments and deliveries in respect of cleared transactions (even if the CM is in default in relation to its obligations to the client) until the corresponding CM/CCP transactions are closed out (which will first require the CCP to declare the CM a “defaulter” in accordance with its rules and procedures (a CM Trigger Event)). Clients should note that, while it is possible that a CM who has defaulted under its Clearing Agreement with its client would also be declared in default under the CCP’s rules and procedures, leading to the relevant CM/CCP transactions being closed out, this is not guaranteed; if a CM defaults in relation to the client transaction but not the related CM/CCP transaction, the CM would not be declared in default by the CCP and the CM/CCP transaction would remain open, in which case the disapplication of Section 2(a)(iii) would oblige the client to keep making payments and deliveries despite the CM’s default under the Clearing Agreement. We view the disapplication of the Section 2(a)(iii) protections as a separate issue from the disapplication of termination rights. Some CMs have shown a willingness to consider amendments to the standard Addendum drafting to prevent clients from having to continue payments and deliveries where the CM is in default. Since cash or collateral transferred to a CM following its default under the Clearing Agreement but prior to the termination of the corresponding CM/CCP transaction will not be protected if the CM fails to pass it on to the CCP, this is something which clients should ask for.

See paragraph 5 of Annex 1 of “EMIR – Gearing Up for Clearing – Part II” for further information in relation to the CCP default management process.

Calculation of termination amount following termination by the CM or automatic termination

As mentioned above, the outcome of termination following any event other than a CM Trigger Event or a CCP Default is the same as if there is a client default. Under Section 9 of the Addendum, if client transactions under the Clearing Agreement are terminated for any reason other than client, CM or CCP default (for instance, due to the application of the “Illegality/Impossibility” election or an agreed termination right by either the CM or the client), the consequences are determined as if an event of default in respect of the client had occurred, e.g. on the CM’s side of the market, even if the event causing termination was in respect of the CM, e.g. the CM exercising its agreed termination right.

The Addendum makes certain changes to the calculation of the termination amount if the CM terminates (either following a client default or a termination event in respect of the client or the CM) or if there is
automatic termination and the non-clearing ISDA Master Agreement is a 1992 ISDA Master Agreement rather than a 2002 ISDA Master Agreement. If the non-clearing ISDA Master Agreement is a 1992 ISDA Master Agreement, the Addendum essentially provides for the termination amount to be determined using the "Loss" payment measure and "Loss" should be determined using the ISDA 2002 methodology for calculating the "Close-out Amount".

In calculating the termination amount, the CM must act in accordance with the "Close-out Standard" (essentially, acting in good faith and using commercially reasonable procedures in order to produce a commercially reasonable result) and is entitled to take into account any unpaid amounts in relation to the Clearing Agreement or Collateral Agreement and any gains realised or losses incurred in connection with closing out transactions, including hedging costs. Following an event of default, termination event or similar event in respect of the client (or a termination event or other similar event in respect of the CM), the CM can take the action it determines most commercially reasonable, which may not be terminating the corresponding CM/CCP transaction but may be, for instance, entering into an offsetting transaction or risk hedging transaction.

**Calculation of termination amount following a CM Trigger Event**

If there is a "CM Trigger Event" due to the CCP declaring the CM a defaulter and the corresponding CM/CCP transactions are terminated by the CCP, thus leading to a termination of the client transactions, the termination amount owed to or by the client is the value of the transactions (deemed by the Addendum to be equal to the value of the relevant CM/CCP transactions), together with any unpaid sums, the value of the collateral attributable to the relevant client transactions and any other amounts attributable to such transactions under the Clearing Agreement, together with interest.

It should be noted that the amendments to the valuation provisions in the Addendum are intended to ensure that the valuation of the client transactions reflects the value of the CM/CCP transactions. The Addendum therefore provides for termination amounts to match the amounts made by the CCP in respect of its transaction with the CM. On a CM Trigger Event, the CCP will calculate the termination amount on its side of the market. As the client has a "back-to-back" relationship with its CM and, in economic terms, takes the opposite side of the transaction to the CCP, the amount due to or payable by the client will always be calculated on the CM's side of the market even where the CM has been declared a defaulter. As part of the limited recourse nature of the Addendum (see also paragraph (M) (Limited Recourse (Section 15)) below), any termination amounts owing to the client are only payable by the CM after the CM has received any portion of the relevant termination amount in respect of the corresponding CM/CCP transactions from the CCP.

**Calculation of termination amount following a CCP default**

The procedure for calculating the termination amount following a CCP default is substantially the same as that following a CM Trigger Event. It should be noted that, as for termination following a CM Trigger Event, if there were outstanding client transactions immediately prior to the occurrence of a CCP default, any applicable termination amount will only be payable after the CM has received any portion of the termination amount from the CCP in respect of the terminated CM/CCP transactions.
L) Limitation of Liability/Indemnity (Sections 12 and 13)

Both “Limitation of Liability” and “Indemnity” are elective provisions in the Addendum. However, it is usual for CMs to specify that these are applicable in the Addendum Annex. The Limitation of Liability provision in the Addendum provides that the liability of the CM and its affiliates to the client excludes losses arising in connection with the performance or non-performance by, or insolvency of, the CCP, any CCP or CM systems failure, breakdown or delay, or actions taken for the purposes of compliance with law or the CCP’s rules and procedures. In addition, there is an exclusion of liability for various categories of loss including consequential loss and loss of profits.

The Indemnity provision in the Addendum provides that the client indemnifies the CM and its affiliates in relation to all losses in respect of client transactions or CM/CCP transactions, including losses caused by the client and the occurrence of a CCP default. This indemnity is very widely drafted, and clients should review it carefully and consider whether to accept it or to suggest amendments to limit their risk.

M) Limited Recourse (Section 15)

In accordance with the "riskless principal" approach, the Addendum provides that the CM’s performance and payment obligations to the client (including in relation to the Collateral Agreement) are contingent on the actual performance or payment by the CCP to the CM in respect of the corresponding CM/CCP transaction. Therefore, clients should note that if there is a default by the CCP, for instance, in circumstances where the CCP becomes insolvent due to the default of other CMs apart from the client’s CM, losses incurred by other CMs would be passed on to clients clearing through those CMs. Deductions or withholdings for or on account of tax are only excluded from being passed on by the CM to the client under this section if the CM can claim under the Addendum Tax Provisions in respect of such deduction or withholding (see paragraph (H) (Tax provisions) above). This is not an elective provision. Although a key aim of mandatory central clearing of OTC derivatives is to make transactions safer for end users, this may not prove to be the case since end users have no way to ensure that CCPs are run responsibly or that their CMs perform their obligations if the CCP does not perform. Under the Addendum, it is the end user who bears the ultimate risk of this.

N) Increased Costs (Section 16)

"Increased Costs" is an elective provision in the Addendum. If this is specified as applicable, the client and CM can negotiate who should bear any "Increased Costs Amounts" which arise in relation to the Clearing Agreement. These are set out in the Addendum Annex. CMs may request a wide definition of Increased Costs and a short Cost Payment Date, such as one business day after receipt of notice of an Increased Cost from the CM. Clients should consider carefully which Increased Costs they are willing to bear and whether any proposed Cost Payment Date would be too short for them before agreeing to these provisions.

Even if this provision is not applied, CMs tend to include other provisions, such as indemnities, in their standard form Clearing Agreements which enable all forms of cost increases to be passed on to their clients.
O) Termination of CCP services (Section 17)

The Addendum allows the parties to specify that the “Termination of Agreed CCP Services”, another elective provision, applies. If this applies, either party may give notice to the other party terminating all client transactions in relation to an agreed CCP service on the notice period specified in the Addendum Annex. Typically, clients are able to terminate on relatively short notice periods, which can vary from one business day to five business days, whereas the CM notice period is usually much longer (generally at least three months) to allow the client time to arrange to port its transactions to a back-up CM if possible or arrange offsetting transactions. If transactions are outstanding once the notice period has elapsed, these automatically terminate.

The parties can provide that any “Additional Transfer Conditions” included as conditions to porting (see paragraph (I) (Pre-default porting and Transfer Conditions (Section 5)) above) also apply upon termination of the service by the CM or client. Since it is the client who is most likely to want to port transactions if the CM gives notice of termination of an agreed CCP service, clients should be wary of accepting the application of Additional Transfer Conditions.

2. THE COLLATERAL AGREEMENT

A client entering into the Addendum will also enter into an associated Collateral Agreement, which (for English law governed transactions) will generally be a CSA with a bespoke form of Paragraph 11 designed by ISDA to work for cleared transactions (see Section 10 of the Addendum). This is achieved by specifying that “Collateral Standard Terms”, an elective provision, applies in the Addendum Annex (see Section 10(a) of the Addendum). The Collateral Agreement will set out the arrangements for the transfer of IM and VM by client and CM.

The bespoke form of paragraph 11 requires certain elections to be made by the CM and client which are made in the “CSA Elections Table” in paragraph 3(c) of the Addendum Annex (or, in the case of the choice of accounts, often in “Table A” in the Addendum Annex).

Key points to note in relation to the Collateral Agreement include the following:

A) Account choice/ level of segregation

CMs may offer clients a number of different account structures and are required by EMIR to offer at least two different account types; individual client segregation (in what is often described as either an “Individually Segregated Account” or an “Individual Client Account”) or omnibus client segregation.

CMs are required to publicly disclose the levels of protection and the costs associated with the different levels of segregation that they provide under EMIR. The choice of account will be reflected in the Addendum

1 EMIR, Article 39(7).
Annex, usually in Table A. Clients should consider carefully which account structure is most suitable for them; in particular, if considering omnibus client segregation, clients should note the additional risks involved in omnibus client segregation, the decreased likelihood of being able to port transactions (both post- and pre-default of the CM), and the fact that there is no obligation under EMIR for the CM to post excess collateral to the CCP (as there is for clients who hold ISAs).

For more information on the segregation of client assets and different account structures, including the advantages and disadvantages of individual client segregation and omnibus client segregation, see Annex 2 (Segregation of client assets and account structures) of “EMIR – Gearing Up for Clearing – Part II”.

B) Eligible Collateral

The Collateral Agreement will specify the types of collateral which are eligible to be posted as IM and VM (in the case of the Addendum, described as IM Eligible Collateral and VM Eligible Collateral). Under EMIR, CCPs are required to accept only highly liquid collateral with minimal credit and market risk\(^2\), which limits the types of collateral which CMs can post to CCPs as IM and VM and consequently the types of collateral which CMs will accept from clients. Collateral requirements differ as between CCPs and will be set out in the CCP’s rules and procedures.

EMIR\(^3\) and the RTS\(^4\) set out which forms of collateral are acceptable as margin and the circumstances they can be posted. VM must generally be in the form of cash; where an election is made in the CSA Elections Table that “Variation Margin Matching” is applicable, this means that the client must transfer cash in the same currency as that called for by the CCP in respect of the corresponding CM-CCP transaction. As a general rule, a wider range of collateral can be posted as IM. Acceptable forms of collateral may include the following:

i) cash;

ii) gold;

iii) government and high-quality corporate bonds;

iv) covered bonds; and

v) bank guarantees (for non-financial counterparties).

\(^2\) EMIR, Article 46(1).

\(^3\) EMIR, Article 46(1)-(3).

\(^4\) RTS 153/2013, Articles 38, 39, 43-46 and Annexes I and II.
However, it is not necessarily the case that clients will be able to post any collateral in the above categories. EMIR and the RTS impose conditions on when such collateral can be posted and require, for instance, that CCPs monitor liquidity risk and concentration risk. In addition, regardless of whether a CCP is currently accepting a particular type of collateral, CMs may impose their own requirements as to what they will accept from clients, either to manage their own risk or, if a CCP has imposed a particular limit on a CM, to ensure that the CM is able to comply with this limit. If it is important to clients that they should always be able to post certain types of collateral, this should be reflected in the Collateral Agreement. Clients should note, however, that CMs will be very reluctant to accept collateral which is not acceptable to the CCP in question since this would prevent the CM from posting the client’s collateral onwards to the CCP and the CM would instead have to provide collateral from other sources to the CCP.

There has been some suggestion that CMs may in the future provide collateral transformation services to clients for an additional fee. This would allow clients to post less liquid or lower-grade collateral to CMs in respect of cleared transactions while CMs would post more liquid or high-quality collateral to CCPs. However, such services are not generally available at the moment.

C) Additional Collateral Amounts

The Collateral Agreement will generally allow for an additional amount of IM (the Additional Collateral Amount) to be provided by the client in respect of client transactions which is over and above that provided by the CM to the CCP in respect of CM-CCP transactions. The Additional Collateral Amount is often structured to include a buffer (commonly referred to as an Operational Buffer) which is provided on day one, and then to give the CM discretion to request an additional amount (which can be up to a multiple of the IM which the CM is required to provide in relation to the corresponding CM-CCP transaction).

To avoid the CM having an unlimited discretion to make calls for further IM, clients will want to negotiate limits to the Additional Collateral Amount which can be demanded; these will typically include a cap on the total amount which the CM can call for (by reference to the initial IM amount requested by the CCP in relation to the corresponding CM-CCP transaction) which will be set out in the CSA Elections Table in the Addendum Annex. In addition, clients should ensure they have sufficient notice periods prior to any increases to be able to meet them and should consider whether a minimum time period between any increases should be included.

D) Margin calls

The Collateral Agreement will specify the procedure for margin calls in respect of IM and VM and for transfer of margin, including the valuation procedure, notification times and whether daily and/or intra-day margin calls are applicable. While many CMs may want to match calls made by CCPs to the extent possible (in accordance with the “riskless principal” approach) to avoid pre-funding a client’s margin requirements and will therefore require the ability to make intra-day margin calls, it is also widely recognised that many clients will not have

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1 See RTS 153/2013 for further detail.
the capability to meet intra-day margin calls. Many CMs, so long as there is a sufficient Operational Buffer in place, will meet intra-day calls in respect of CM-CCP transactions but will only make margin calls on clients on a daily basis.

When negotiating Collateral Agreements, clients should ensure that the provisions around margin calls reflect their operational capabilities and commercial needs. For instance, they should ensure that they can comply with the notification times which are agreed with the CM and, if intra-day margin calls are applicable, that they are operationally able to meet these. Clients based in a different jurisdiction from their CM may wish to consider whether they are equipped to meet margin calls on days which are business days in that jurisdiction but may not be business days in their own jurisdiction.

E) Return of collateral

The Collateral Agreement will specify the types of collateral which the CM can return to the clients. Clients who wish to receive back the same types of collateral which they have posted should ensure that this is provided for in the documentation and that CMs do not have the right to substitute the client’s collateral balance with collateral of an equivalent value. Many CMs will, however, insist that the election “Client Matched Demands” applies in the CSA Elections Table so that they can return different collateral to that posted by the client in circumstances where the CCP returns different collateral to them since, according to the “riskless principal” approach, they will not want to be “on the hook” for any mismatch and will simply want to pass on the collateral returned by the CCP, whether or not this is different to that originally posted by the client.

If clients wish to ensure that they can receive back the same collateral as they post to the CM, “Client Discretionary Demands” should apply rather than “Client Matched Demands”. This gives clients the right to specify in their demands for the return of collateral the amounts, types and denominations of collateral comprised in their credit support balance at the CCP which they want the CM to transfer to them. However, in addition to applying Client Discretionary Demands, clients must also ensure that “Substitution” (which gives the CM the right to substitute the client’s credit support balance with collateral having an equivalent value to the client’s original collateral) is switched off. Furthermore, the client should also limit the application of “Collateral Modification Events” (see below at paragraph (F) (Modification of margin provisions by CM)), as a CM might seek to rely on this (if specified as applicable) to returning different collateral to the client if the CCP returns different collateral to it, even if “Client Discretionary Demands” has been applied and “Substitution” is inapplicable.

F) Modification of margin provisions by CM

CCPs will normally retain a wide discretion to make changes upon notice to the CM to their margin methodology. In accordance with the “riskless principal” approach, CMs will seek in their Clearing Agreements with clients to be able to unilaterally modify the collateral provisions to reflect these changes. This is often achieved by specifying that “Collateral Modification Events” is applicable in the CSA Elections Table. If this applies, the CM may modify the Collateral Agreement to account for any amendment or modification by the CCP to the margin methodology it applies to the corresponding CM/CCP transaction which means that the Collateral Agreement no longer reflects the commercial agreement between the parties in relation to the collateral arrangements in respect of the relevant client transaction.
Where this is applicable, clients should note that this might allow a wide range of changes to be made unilaterally by the CM to their collateral arrangements (and so should consider whether the right to make modifications should be appropriately limited) and should ensure that the notice period for any changes to be effective is sufficient to enable compliance. If it is agreed with the CM that some aspects of the collateral arrangements will not be unilaterally modified by the CM, such as notification times or the right of the client to meet only one daily call, this should be expressly reflected in the Collateral Agreement.
**Annex 3**

**Updates to “EMIR – Gearing Up for Clearing – Part I”**

The following developments update certain issues outlined in our first briefing (“EMIR – Gearing Up for Clearing – PART I”, March 2015).6

**THE PENSIONS EXEMPTION**

Please read this update together with the section headed “THE PENSIONS EXEMPTION” in Annex 3 “Exemptions to Clearing” in our first briefing.

Pension fund arrangements are subject to a transitional exemption from clearing in respect of OTC derivative contracts that are objectively measurable as reducing investment risks directly relating to the financial solvency of the pension scheme arrangement. The transitional exemption also applies to entities established for the purpose of providing compensation to members of pension scheme arrangements in case of default. The exemption which was due to expire on 16 August 2015 was extended, by the EC’s adoption of a delegated act on 5 June 2015, by a further two years until 16 August 2017. The delegated regulation entered into force on 16 September 2015.

**CLEARING OF INTEREST RATE DERIVATIVES**

Please read this update together with the section headed "Which classes of OTC derivatives are in the pipeline for mandatory clearing?" in (and the relevant explanation and definitions within) our first briefing.

In our first briefing, we discussed the Amended Draft IR RTS, which relates to the regulatory technical standards for the introduction of mandatory central clearing for the first classes of OTC interest rate derivatives denominated in EUR, GBP, JPY and USD (G4 currencies). On 6 August 2015, the EC adopted a delegated regulation in respect of the Amended Draft IR RTS. The delegated act is currently subject to review and scrutiny by the European Parliament and Council of the European Union (which have a period of up to three months, subject to extension by a further three months, to do so). Only once it is published in the Official Journal of the European Union will this give certainty as to when the phasing-in of the mandatory clearing obligation will start. The delegated act is in line with the opinion issued by ESMA in January, and revised in March, of this year. However, there are a couple of points which are worth highlighting in this briefing.

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6 These updates should be read together with the updates outlined in Annex 3 of our second briefing (“EMIR – Gearing Up for Clearing – PART II”, 20 May 2015)
Intra-group exemption in relation to non-EU counterparties

In our first briefing, we discussed the temporary solution to enable certain intra-group transactions between an EU entity and a non-EU counterparty in a jurisdiction which has not been granted “equivalence” to benefit from the “intra-group exemption” to clearing. The temporary solution put forward by the EC proposed that such non-EU jurisdictions should be deemed to be “equivalent” for three years after the interest rate RTS is effective or, if earlier, until an “equivalence” decision is adopted for the relevant jurisdiction. The treatment of these transactions has been changed in the delegated act. The obligation to clear intra-group transactions between an EU entity and a non-EU counterparty, which satisfy certain conditions, will begin 3 years following the date of entry into force of the delegated act or, if an equivalence decision is adopted regarding a third country, a date following such decision. There will be no requirement to frontload any such transactions entered into or novated before the clearing obligation takes effect. This achieves the same goal of providing transitional relief until the EC has determined whether the rules in non-EU jurisdictions are “equivalent”. This transitional relief does not apply to counterparties in Category 4 since they are already subject to a 3 year phase-in of the mandatory clearing obligation.

Covered bond exclusion

The treatment of interest rate derivatives in the context of covered bonds was not included within the scope of the first briefing. The classes of OTC interest rate derivatives to which the clearing obligation applies under the delegated regulation do not include contracts concluded with covered bond issuers or with cover pools for covered bonds, provided those contracts satisfy certain conditions. The delegated act clarifies one of those conditions to makes it clear that a contract must not allow for termination in case of resolution or insolvency of the covered bond issuer or the cover pool.

Counterparty categorisation

In our first briefing we explain the Counterparty Categorisation Threshold which is used for the purpose of categorising counterparties (into Category 2 or Category 3) according to their levels of OTC derivatives activity for applying a phased-in implementation of the mandatory clearing obligation. The aggregate month end average notional amount of all non-centrally cleared derivatives for the three months after the publication of the RTS in the Official Journal (not including the month of publication) is calculated to determine whether the EUR 8 billion threshold is exceeded. Where a counterparty forms part of a group, all of the group’s non-centrally cleared derivatives will be taken into account for the calculation. However, in line with ESMA’s opinion and the Amended Draft IR RTS, the calculation for investment funds which are AIFs and UCITS should be applied separately to each fund. The recitals of the delegated regulation state that this treatment should apply as long as, in the event of fund insolvency or bankruptcy, each investment fund constitutes a completely segregated and ring-fenced pool of assets that is not collateralised, guaranteed or supported by other investment funds or the investment manager itself.

CLEARING OF CREDIT DERIVATIVES

Please read this update together with the section headed "Which classes of OTC derivatives are in the pipeline for mandatory clearing?" in (and the relevant explanation and definitions within) our first briefing.
On 2 October 2015, ESMA published the final draft RTS for the central clearing of credit default swaps (CDS). The final RTS impose a clearing obligation in respect of the same CDS as proposed in the draft RTS published in July 2014: CDS on untranche d iTraxx Europe Main Index and untranche d iTraxx Europe Crossover Index (in each case, series 17 onwards) which are settled in Euro and have a tenor of 5 years.

The counterparty categorisation (which determines the start date for clearing of these CDS classes) is the same as for the clearing obligation in respect of interest rate derivatives denominated in G4 currencies. However the phase-in implementation timeline for counterparties in Category 1, Category 2 and Category 3 is different.

The proposed phased-in implementation schedule for mandatory clearing of the first classes of CDS is as follows:

<table>
<thead>
<tr>
<th>Counterparty</th>
<th>Start date for mandatory clearing (months/years after the RTS enter into force)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Category 1</td>
<td>9 months</td>
</tr>
<tr>
<td>Category 2</td>
<td>15 months</td>
</tr>
<tr>
<td>Category 3</td>
<td>21 months</td>
</tr>
<tr>
<td>Category 4</td>
<td>3 years</td>
</tr>
</tbody>
</table>

As is the case for the clearing obligation in respect of interest rate derivatives denominated in G4 currencies:

1) the obligation to clear intra-group transactions between an EU entity and an non-EU counterparty, which satisfy certain conditions, will begin 3 years following the date of entry into force of the RTS or, if an equivalence decision is adopted regarding a third country, a date following such decision;

2) when calculating the aggregate month end average notional amount of all non-centrally cleared derivatives for the purpose of determining whether EUR 8 billion threshold is exceeded for counterparty categorisation, the calculation is carried out on a group basis except in the case of investment funds (see above under “CLEARING OF INTEREST RATE DERIVATIVES - Counterparty Categorisation”); and

3) the frontloading obligation only applies to counterparties in Category 1 and Category 2.

The frontloading start date, in respect of counterparties in both Category 1 and Category 2, is set for five months after the RTS enter into force (as opposed to 2 months and 5 months, respectively, when compared with the clearing obligation in respect of interest rate derivatives for G4 currencies). This effectively means that

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7 Note however that the determination of counterparty categorisation is to be carried out on the same months as proposed in the RTS for the clearing obligation in respect of interest rate derivatives for G4 currencies and not by reference to when the RTS for CDS are published in the Official Journal.
counterparties in Category 1 and Category 2 will be obliged on the clearing start date to clear existing CDS (which are in scope) to the extent that the contract (i) is entered into (or novated) on or after the date which is 4 months (in the case of Category 1) or 10 months (in the case of Category 2) before the start date for the clearing obligation and (ii) has a minimum remaining maturity of 6 months as at the start date for the clearing obligation.

The RTS are now subject to a three month period of review by the EC before being subject to a further period of scrutiny by the European Parliament and Council of the European Union before being published in the Official Journal. The RTS could enter into force as early as February 2016 meaning that the clearing obligation for the first classes of CDS could potentially start for counterparties in Category 1 as early as November 2016.