

Overview

Cleared Derivatives Addendum

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Cleared Derivatives Addendum

Contributed by GuyLaine Charles of [Charles Law PLLC](#)

This article focusses on the Cleared Derivatives Addendum published in 2012 by the Futures Industry Association (“FIA”) and the International Swaps and Derivatives Association, Inc. (“ISDA”) as well as the alternative form of the Cleared Derivatives Addendum published in 2018 (collectively, the “CDA”). The CDA was created to address clearing of swaps regulated by the Commodity Futures Trading Commission (the “CFTC”) whether subject to mandatory clearing or voluntarily cleared. Security-based swaps regulated by the Securities and Exchange Commission may also be subject to a clearing requirement after the [security-based swap rules](#) become effective all at once on October 6, 2021, if so we expect ISDA together with FIA and the Securities Industry and Financial Markets Association to engage with market participants to come up with a solution.

Before the [Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (“Dodd-Frank”), the small number of cleared swap transactions were handled by Futures Commission Merchants (“FCM”) accessing futures clearinghouses on behalf of their customers, and the FCMs used their own futures account agreements to govern the relationship with their customers. Dodd-Frank required that swaps [designated by the CFTC for mandatory clearing](#) be cleared through “[derivatives clearing organizations](#)” (“DCOs”), (with some exceptions for commercial end users and others entering into swaps) and that only FCMs would be permitted to clear swaps through DCOs. As a result, the clearing FCMs (the “Clearing Members”) now find themselves as intermediaries between their customers and the DCOs for a large number of economically significant swap transactions.

The interest rate swaps and credit default index swaps that the [CFTC has designated for mandatory clearing](#) are listed in Exhibit I. DCO's may accept swaps for clearing that are not subject to the clearing requirement, and those are treated similarly to swaps subject to the clearing requirement.

FIA and ISDA did not attempt to draft a stand-alone master agreement for cleared swaps to govern the relationship between the Clearing Member and its customer. Clearing Members have policies which are specific to their organization addressing credit concerns, house margining requirements, default and close-out provisions, and other matters. Therefore, the individually negotiated customer-Clearing Member futures account agreement remains the foundation for cleared swap transactions. However, the DCOs’ rules posed problems for Clearing Members, especially with regard to the Clearing Member's obligations to the DCO if a customer defaulted to the Clearing Member. Customers were also concerned about protecting themselves if the Clearing Member defaulted to the DCO, or if the DCO were to become insolvent. These issues were found to be too complex for each Clearing Member to navigate individually and further, the DCOs advocated for a uniform scheme. The structure of a cleared swap in the U.S., the “agency model,” is used where the [Clearing Member](#) is legally the agent of its customer, and has a direct relationship with the DCO.

Under this model a cleared swap transaction proceeds as follow:

A customer executes its order on a swap execution facility (“SEF”) directly or through an intermediary or if the swap is not made available to trade on a SEF, bilaterally with an executing broker. The Cleared Derivatives Execution Addendum (the “CDEA”) is used between counterparties to address the issue of clearing certainty. SEFs have their own participant agreements.

The 2011 original version (1.0) of the CDEA has been superseded in the U.S. by the 2012 (1.1) version. This responded to a CFTC rule invalidating the 2011 CDEA because it contained optional provisions allowing Clearing Members to obtain information about otherwise anonymous transactions, which created concerns of anticompetitive conduct by Clearing Members. SEF have their own agreement.

The executed transaction is submitted to the customer's Clearing Member, which, after reviewing the transaction's compliance with position limits and credit requirements, submits it for clearing to a DCO of which it is a member. The counterparty does the same.

Upon acceptance by the DCO, the transaction is novated and becomes for legal purposes a trade between the DCO and the customer acting through its agent the Clearing Member (the “novated trade”). An offsetting transaction is also established between the DCO and the counterparty.

Under the DCO rules, all transfers of funds and communications must be done through the Clearing Member and the Clearing Member is responsible to the DCO for all performance of its customer under the novated transaction. Accordingly, the DCO - Clearing Member - customer relationship is best analyzed as two back-to-back relationships: DCO - Clearing Member and Clearing Member - customer.

The Clearing Member acts as both a member of the DCO and as agent of its customers.

The Cleared Derivatives Addenda

The [CDA](#) is a limited purpose addendum to the underlying agreement between the Clearing Member's customer and the Clearing Member (the "Agreement"). The Agreement is a futures account agreement which includes security interest provisions to govern collateral.

Clearing Members typically make and accept changes in the body of the [CDA](#). If they do so, they are at a minimum required to add the following statement to the copyright notice or otherwise: "This document is based on the Addendum standard published by the FIA and ISDA. As permitted by the license [the parties] have revised the published document. The publishers' version can be reviewed at www.futuresindustry.org and www.isda.org." Customers' counsel should check for this language or similar language in footnotes and if found, compare the Clearing Member's form carefully to the standard language.

The [CDA](#)'s primary purpose is to protect the Clearing Member in its status as intermediary between its customer and the Clearing Organization (as defined below). The [CDA](#) limits or eliminates many of the customer's rights against the Clearing Member to protect the Clearing Member from being whipsawed between the customer and the Clearing Organization. Clearing Members generally see these limitations as essential while customers may have concerns that they may be overreaching.

The one major difference between the 2012 [CDA](#) and the 2018 [CDA](#) is the treatment of closeout if the customer defaults on its obligations to its Clearing Member. The 2012 version empowers the Clearing Member to enter into Close-Out Transactions, Risk-Reducing Transactions or Mitigation Transactions (each as defined below). The 2018 version adds Replacement Transaction (as defined below) to the Clearing Member's arsenal of remedies. Accordingly, the discussion of the 2012 [CDA](#) provisions is equally applicable to the 2018 version. The differences caused by the addition of the Replacement Transactions option in the 2018 version will be briefly summarized below. Both versions are in current use, depending on whether the DCO supports Replacement Transactions as a liquidation method and the parties' views on Replacement Transactions.

Section 1(a) - Cleared Derivatives Transactions

Section 1(a) of the [CDA](#) provides that the [CDA](#) applies to all swaps, forwards, options or similar transactions, whether OTC or exchange-traded, if the trades are submitted to a DCO or other clearing organization (together with a "DCO," a "Clearing Organization") and carried in a customer account. Transactions subject to the [CDA](#) are "Cleared Derivatives Transactions." Futures traded on designated contract markets or overseas futures exchanges are not Cleared Derivatives Transactions.

Section 4 - Transaction not Accepted for Clearing

Section 4 of the [CDA](#) addresses the fact that if a transaction is not accepted for clearing the "Clearing Member shall have no further rights or obligations hereunder with respect to such transaction." While this may be appropriate if the Clearing Member was in no way responsible for the failure to clear, but is less reasonable to the extent the failure to be accepted for clearing results from the Clearing Member's negligence or is otherwise its fault. Some customers will include language in the [CDA](#) to ensure that they will be indemnified for such failure.

Section 6 - Transfer of Positions

The most important right for customers is found in Section 6 of the [CDA](#). This provision reiterates the customer's right under NFA Compliance Rule 2-27,¹ to cause the Clearing Member to transfer Cleared Derivatives Transactions to another Clearing Member ("porting") so long as there is not a Close-Out Event in progress. Note, however, that the language in 2-27 is not prescriptive and allows the Clearing Member to take "further time as may be necessary" to complete the porting. The porting right is essential to the customer in the following situations:

1. Default by the Clearing Member with the customer where the Clearing Organization does not place the Clearing Member in default; if the customer loses its contractual default rights against the Clearing Member its only effective response is to port its positions away from such Clearing Member.
2. The Clearing Member reduces or terminates its participation in the Clearing Organization without defaulting to the Clearing Organization.

If any such event happens a customer may want to ensure that its positions will be ported within a reasonable period of time. Some customers negotiate Section 6 of the [CDA](#) to ensure that porting will occur within a specified number of days of their request. As a practical matter, customers if possible should set up accounts with backup Clearing Members well before any issues surface with their existing Clearing Member.

Section 7 - Liquidation Upon a Close-out Event or Tax Liquidation Event

The liquidation provisions of Section 7 of the [CDA](#), which are triggered by default by the customer or a Tax Liquidation Event (defined and discussed below in the analysis of Section 8) are the most important and complex terms of the [CDA](#). They comprise 10 of the 20 pages of the [CDA](#). Unlike similar European cleared derivatives documentation, the [CDA](#) does not contain provisions triggered by default of the Clearing Member or the Clearing Organization. Customers must look to the Agreement for their rights, if any, in such situations.

Only Cleared Derivatives Transactions held in the customer's Cleared Derivatives Account and that are subject to close-out ("Designated Transactions") are subject to the Section 7 liquidation provisions. Section 7(o) of the [CDA](#) defines the Liquidation Standard, as a general requirement for fair dealing by the Clearing Member in taking action under Section 7. It provides that the Clearing Member must act in good faith, comply with applicable Law (including Clearing Organization rules) and use commercially reasonable procedures to produce a commercially reasonable result. If the Clearing Member effects Mitigation Transactions (as defined below) with itself or its affiliates, it must do so on an arm's length basis at then prevailing market prices that are commercially reasonably determined by the Clearing Member. If there are no such market prices or the prices would violate the Liquidation Standard, the Clearing Member may execute those transactions at arm's length and at a commercially reasonable price.

Section 7(o) also defines several types of liquidating transactions that the Clearing Member may use. The first three are available under both the 2012 [CDA](#) and the 2018 [CDA](#).

¹ RULE 2-27. TRANSFER OF CUSTOMER ACCOUNTS.

[Adopted effective January 24, 1985.]

(a) Upon receipt of a signed instruction from a customer to transfer an account from one Member to another, and provided that such instruction contains the customer's name, address and account number (and, if the transfer is not of the entire account, a description of which portions are to be transferred) and the name and address of the receiving Member, the carrying Member shall confirm to the receiving Member all balances in the account, whether money, securities or other property, and all open positions, within two business days or within such further time as may be necessary in the exercise of due diligence. Within three business days of the day such confirmation is due, or within such further time as may be necessary in the exercise of due diligence, and provided that the receiving Member agrees to accept the account, the carrying Member shall effect the transfer of the balances and positions to the receiving Member.(b) This rule shall apply only to transfers made at the request of a customer.(c) This rule shall not prohibit transfers based upon oral requests.

Close-Out Transactions - are opposing transactions executed in the customer's account and cleared on the same Clearing Organization as the Designated Transactions. These include Offsetting Transactions (conventional offsets) and Sale/Novation Transactions (a sale, novation or assignment of customer's position).

Risk-Reducing Transactions - are cleared transactions effected in the customer's account (with a third party or with the Clearing Member or its affiliate) that hedge or reduce risk but that are not Sale/Novation Transactions. Here is an example: customer's Designated Transaction is a 6 mo. USD interest rate swap but for some reason 6 mo. contracts are not trading or are illiquid, so the Clearing Member does an offsetting 3 mo. cleared swap.

Mitigation Transactions - are transactions effected by the Clearing Member or its affiliate to hedge or reduce risk of the Designated Transactions, but which are not effected in the customer's account and which need not be cleared. Here is an example: if the Clearing Member cannot offset a customer's GBP swap but reasonably figures it can reduce exposure by trading an offsetting OTC swap for its own account.

The innovation made by Section 7(a)(ii)(y) of the 2018 [CDA](#) is to add "Replacement Transactions" to the Clearing Member's liquidation arsenal. If the Clearing Organization's rules permit, the Clearing Member may enter into transactions materially identical to the customer's Designated Transactions with the Clearing Organization, for the Clearing Member's account. On doing so, the Clearing Member can terminate the customer's Designated Transactions with the Clearing Organization, and charge the customer a Termination Amount for any loss it incurs. The Clearing Member must then enter into Replacement Offsetting Transactions or Mitigation Transaction to close out the trade.

Section 7(a) prescribes notice requirements and designates the Liquidation Date (the date on which close-out amounts are calculated) and empowers the Clearing Member to use any of the liquidation transactions listed above. Section 7(a)(ii)(B)(1) contains a complex provision empowering the Clearing Member to value liquidating transactions on its own if it concludes that Close-Out Transactions or Risk Reducing Transactions are not available or if effected would be inconsistent with the Liquidation Standard, or if soliciting quotes in the market would result in valuations inconsistent with the Liquidation Standard (presumably by materially affecting quotes). Transactions so valued are deemed to have been liquidated.

Section 7(b) specifies the computation of Termination Amounts for each liquidation or deemed liquidation of a Designated Transaction or Risk-Reducing Transaction. Note that the computation here, although it starts from the familiar ISDA Close-Out Amount, could vary materially because of the use of Risk-Reducing, Mitigation and, possibly, Replacement Transactions. The basic computation is the sum of trading losses or gains incurred by the Clearing Member in entering into liquidating transactions plus some additional amounts and expenses. Specifically it includes:

- For transactions deemed liquidated, the sum of valuations of those transactions as of the Close-Out Date (the date on which a liquidating transaction or deemed liquidation occurs). Third party marks and data are preferred unless inconsistent with the Liquidation Standard, in which case internal sources and models may be used by the Clearing Member consistent with the Liquidation Standard;
- Amounts due and unpaid by the customer to the Clearing Member or a Clearing Organization, offset by amounts due and unpaid by the Clearing Member or a Clearing Organization to the customer or the Clearing Member; provided that no offset is taken for amounts due from a Clearing Organization to a Clearing Member until actually paid or credited; and
- Reasonable, documented out-of-pocket expenses and costs of funding incurred by the Clearing Member or its affiliates. Note 7 to the [CDA](#) suggests that the parties may wish to define or limit costs of funding, and suggests language limiting it to cost of funds posted as margin or collateral at a specified interest rate. Both parties may wish to pursue this suggestion.

Section 7(c) details the Clearing Member's rights to sell or dispose of Credit Support under the [CDA](#), realize on assets held in the customer's Cleared Derivatives Account and apply them to amounts owed under the [CDA](#), and take other actions as permitted by Applicable Law. Notes 8 and 9 point out that all these rights under the [CDA](#) are limited to assets held under or subject to the [CDA](#). Clearing Members are very likely to propose extending these rights to all assets held by them and all obligations owed to them. Careful attention should be paid to the corresponding provisions in the underlying Agreement.

Section 8 - Tax Provisions

The second longest provision of the [CDA](#) is Section 8, which contains tax provisions similar to those in the ISDA and other master agreements.

The parties state that they do not expect to be subject to withholding tax requirements and that the Clearing Member does not expect the Clearing Organization to withhold tax. FATCA withholding tax is excepted.

If the customer is required to withhold on payments to the Clearing Member or if the Clearing Member is required to withhold on payments to Clearing Organization, the customer must gross up its payments to the Clearing Member to equal amounts payable by the Clearing Member to the Clearing Organization. The customer is not obligated to gross up if the withholding tax is caused by a connection of the Clearing Member to the taxing jurisdiction, a merger or reorganization of the Clearing Member, failure of the Clearing Member to provide accurate tax documentation, the Clearing Member's failure to comply with FATCA, or Clearing Member's failure to provide necessary tax documents to the relevant Clearing Organization. There is no reciprocal obligation for Clearing Member to gross up if the Clearing Organization withholds on amounts paid to Clearing Member.

If either party fails to withhold tax, the payee is required to indemnify the payor for taxes and penalties assessed, unless caused by the payor's gross negligent or willful misconduct. Further, if a Clearing Organization assesses Clearing Member for tax liabilities related to a Cleared Derivative Transaction, the customer must indemnify Clearing Member unless Clearing Member violated specified obligations in the [CDA](#).

A "Tax Liquidation Event" occurs if there is a substantial likelihood that the Clearing Member, because of a merger or change in tax law, will not be entitled to receive gross-up amounts under Section 8(a)(iii) (discussed above) or will be required to pay additional amounts to the customer in respect of tax. In that event, the Clearing Member can terminate and close out any transactions affected by the Tax Liquidation Event.

Other provisions

Unless already covered in the Agreement, the customer may consider the following additions to the CDA:

1. Including a provision stating that the Clearing Member may not require more initial margin than what is required by the Clearing Organization. If the Clearing Member does want to increase such margin, the Clearing Member must provide [# of days] prior notice to the Customer. Customers may also prohibit the increase of margin by more than a stated percentage of notional and/or place a cap on the initial margin that can be requested.
2. Customers may propose valuation language requiring the Clearing Member to use in computing margin obligations the valuations of positions and collateral that are used by the Clearing Organization. A desirable provision for customers is a requirement for central counterparty exposure matching, which requires that the Clearing Member compute variation margin obligations to match the variation margin computations made by the Clearing Organization.
3. Section 2 of the [CDA](#) contains representations, warranties and covenants ("statements"). The preamble reiterates all such statements made by the customer in the Agreement on the execution date of the [CDA](#) and on all dates on which a Cleared Derivatives Transaction is accepted for clearing, but the Clearing Member does not reiterate any of its statements made in the Agreement. It may be beneficial to have the Clearing Member also reiterate the statements it makes in the Agreement and have those statements be continuous or at least repeated on all dates on which a Cleared Derivatives Transaction is accepted for clearing.
4. A Clearing Member may include a provision in the Schedule or revise the [CDA](#) to provide that the Clearing Member may unilaterally reduce its limits or may reduce them on behalf of the Clearing Organization. Customers may counter that the reduction should not apply to existing transactions accepted for clearing, so that the customer is not obligated to close out or otherwise reduce its existing positions, and that the reduction takes effect only after [# days] receipt of notice.

Like all industry published standard form documents, the [CDA](#) is subject to negotiation and should be carefully reviewed by customers and appropriately negotiated.

EXHIBIT I

(a) Interest rate swaps.

Specification	Fixed-to-floating swap class					
1. Currency	Australian Dollar (AUD)	Canadian Dollar (CAD)	Euro (EUR)	Hong Kong Dollar (HKD)	Mexican Peso (MXN)	Norwegian Krone (NOK).
2. Floating Rate Indexes	BBSW	CDOR	EURIBOR	HIBOR	TIE-BANXICO	NIBOR.
3. Stated Termination Date Range	28 days to 30 years	28 days to 30 years	28 days to 50 years	28 days to 10 years	28 days to 21 years	28 days to 10 years.
4. Optionality	No	No	No	No	No	No.
5. Dual Currencies	No	No	No	No	No	No.
6. Conditional Notional Amounts	No	No	No	No	No	No.

Specification	Fixed-to-floating swap class						
1. Currency	Polish Zloty (PLN)	Singapore Dollar (SGD)	Swedish Krona (SEK)	Swiss Franc (CHF)	Sterling (GBP)	U.S. Dollar (USD)	Yen (JPY).
2. Floating Rate Indexes	WIBOR	SOR-VWAP	STIBOR	LIBOR	LIBOR	LIBOR	LIBOR.
3. Stated Termination Date Range	28 days to 10 years	28 days to 10 years	28 days to 15 years	28 days to 30 years	28 days to 50 years	28 days to 50 years	28 days to 30 years.
4. Optionality	No	No	No	No	No	No	No.
5. Dual Currencies	No	No	No	No	No	No	No.
6. Conditional Notional Amounts	No	No	No	No	No	No	No.

Specification	Basis swap class				
1. Currency	Australian Dollar (AUD)	Euro (EUR)	Sterling (GBP)	U.S. Dollar (USD)	Yen (JPY).
2. Floating Rate Indexes	BBSW	EURIBOR	LIBOR	LIBOR	LIBOR.
3. Stated Termination Date Range	28 days to 30 years	28 days to 50 years	28 days to 50 years	28 days to 50 years	28 days to 30 years.
4. Optionality	No	No	No	No	No.
5. Dual Currencies	No	No	No	No	No.
6. Conditional Notional Amounts	No	No	No	No	No.

Specification	Forward rate agreement class						
1. Currency	Euro (EUR)	Polish Zloty (PLN)	Norwegian Krone (NOK)	Swedish Krona (SEK)	Sterling (GBP)	U.S. Dollar (USD)	Yen (JPY).
2. Floating Rate Indexes	EURIBOR	WIBOR	NIBOR	STIBOR	LIBOR	LIBOR	LIBOR.
3. Stated Termination Date Range	3 days to 3 years	3 days to 2 years	3 days to 2 years	3 days to 3 years	3 days to 3 years	3 days to 3 years	3 days to 3 years.
4. Optionality	No	No	No	No	No	No	No.
5. Dual Currencies	No	No	No	No	No	No	No.
6. Conditional Notional Amounts	No	No	No	No	No	No	No.

Specification	Overnight index swap class				
1. Currency	Australian Dollar (AUD)	Canadian Dollar (CAD)	Euro (EUR)	Sterling (GBP)	U.S. Dollar (USD).
2. Floating Rate Indexes	AONIA-OIS	CORRA-OIS	EONIA	SONIA	FedFunds.
3. Stated Termination Date Range	7 days to 2 years	7 days to 2 years	7 days to 3 years	7 days to 3 years	7 days to 3 years.
4. Optionality	No	No	No	No	No.
5. Dual Currencies	No	No	No	No	No.
6. Conditional Notional Amounts	No	No	No	No	No.

(b) Credit default swaps.

Specification	North American untranched CDS indices class
Reference Entities	Corporate.
Region	North America.
Indices	CDX.NA.IG; CDX.NA.HY.
Tenor	CDX.NA.IG: 3Y, 5Y, 7Y, 10Y; CDX.NA.HY: 5Y.
Applicable Series	CDX.NA.IG 3Y: Series 15 and all subsequent Series, up to and including the current Series.
	CDX.NA.IG 5Y: Series 11 and all subsequent Series, up to and including the current Series.
	CDX.NA.IG 7Y: Series 8 and all subsequent Series, up to and including the current Series.
	CDX.NA.IG 10Y: Series 8 and all subsequent Series, up to and including the current Series.
	CDX.NA.HY 5Y: Series 11 and all subsequent Series, up to and including the current Series.
Tranched	No.

Specification	European untranched CDS indices class
Reference Entities	Corporate.
Region	Europe.
Indices	iTraxx Europe.
	iTraxx Europe Crossover.
	iTraxx Europe HiVol.
Tenor	iTraxx Europe: 5Y, 10Y.
	iTraxx Europe Crossover: 5Y.
	iTraxx Europe HiVol: 5Y.
Applicable Series	iTraxx Europe 5Y: Series 10 and all subsequent Series, up to and including the current Series.
	iTraxx Europe 10Y: Series 7 and all subsequent Series, up to and including the current Series.
	iTraxx Europe Crossover 5Y: Series 10 and all subsequent Series, up to and including the current Series.
	iTraxx Europe HiVol 5Y: Series 10 and all subsequent Series, up to and including the current Series.
Tranched	No.