

Explanatory memorandum to the form of the ISDA EMIR Frontloading Additional Termination Event Amendment Agreement

International Swaps and Derivatives Association, Inc. (“ISDA”) has prepared this explanatory memorandum to assist in your consideration of the form of the ISDA EMIR Frontloading Additional Termination Event Amendment Agreement published by ISDA on 12th June 2015 (the ‘Frontloading ATE Amendment Agreement’).

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INTRODUCTION TO THE FRONTLOADING ATE AMENDMENT AGREEMENT

Mandatory clearing and frontloading

One of the key requirements being introduced to the derivatives market by EMIR¹ is the mandatory clearing of OTC derivative contracts (Article 4 of EMIR): transactions meeting set criteria, between certain counterparty types, must be cleared with an appropriately authorised or recognised central counterparty. The relevant criteria will be set out in regulatory technical standards (**RTS**), currently being developed by the European Securities and Markets Authority and the European Commission.

Each RTS for a given set of transaction types will specify the date from which mandatory clearing applies (the **Clearing Start Date**). Mandatory clearing will be phased-in so, in fact, the RTS will specify a series of Clearing Start Dates and a categorisation methodology for determining which Clearing Start Date applies between any two entities.

For the majority of market participants which are in a category subject to mandatory clearing and which are entering into transactions of a class subject to mandatory clearing, only new transactions, entered into on or after the Clearing Start Date, will have to be cleared. However, some market participants will have to clear transactions entered into during a given period (the **frontloading window**) leading up to the Clearing Start Date.

This additional EMIR requirement, known as **frontloading**, is the source of additional risk of regulatory breach. The parties may enter into a derivative contract during the frontloading window in the belief that, by the Clearing Start Date, they will have agreed the clearing documentation necessary to clear the contract but then find they reach the Clearing Start Date without the requisite documentation being finalised. This could occur for a number of reasons, including due to events outside the parties’ control such as the withdrawal of a service provider.

If clearing by the Clearing Start Date is not possible, the only way the parties can avoid breach of the frontloading requirement (or stop a breach that has occurred from continuing) is to terminate the problem contract. The Frontloading ATE Amendment Agreement provides the required² termination right, so reduces the risk of regulatory breach faced by market participants subject to frontloading.

¹ Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

² The standard form of the ISDA Master Agreement does not include a termination right for failure to clear a transaction by its Clearing Start Date.

The Frontloading ATE Amendment Agreement

The Frontloading ATE Amendment Agreement is an amendment agreement by which the parties to an ISDA Master Agreement (1992 or 2002) can amend such agreement to incorporate a new Additional Termination Event covering frontloading (the **Frontloading ATE**). The first two pages are the amendment agreement, to which is attached the Frontloading ATE itself. The Frontloading ATE Amendment Agreement is a standard form document, it can be amended and, indeed, it is envisaged that users of this document will amend it to suit their particular circumstances.

The Frontloading ATE

The Frontloading ATE is an Additional Termination Event as defined in the ISDA Master Agreement. In accordance with Sections 5(b) and 6(b)(iv) of the ISDA Master Agreement, the occurrence (and continuance) of the Additional Termination Event grants a right of termination in respect of all Affected Transactions.

The first paragraph of the Frontloading ATE sets out the event: that one or more Transactions required to be Cleared under Article 4(1)(b)(ii) of EMIR (the specific provision in EMIR which requires frontloading) are not Cleared by the Clearing Deadline.

Sub-paragraph (1) confirms that if the event does occur, the only Transactions which are capable of being terminated (the “Affected Transactions”) are those directly subject to the event. Without this line, the occurrence of the event could lead to all Transactions under the ISDA Master Agreement being terminated.

Sub-paragraph (2) allows the parties to specify which of them will be the “Affected Part[y]/[ies]” and for what purpose. Essentially:

- if there is just one Affected Party, then the other party (i) is the only party which has the right to terminate the Affected Transactions; and (ii) is the party which determines the value of the Affected Transactions on their termination; or
- if both parties are Affected Parties, then both parties have the right to terminate and both parties perform the valuation (with the final value being the mid-point between the two parties’ valuations).

However, the language in sub-paragraph (2) does allow for standard variations of the above, such as providing that Party B is the sole Affected Party but both parties are Affected Parties for the purposes of Section 6(b)(iv) of the relevant ISDA Master Agreement, meaning both parties have the right to terminate but valuation will be done by Party A.

The next paragraph, including sub-paragraphs (A) and (B), set out several suggested variations from the standard ISDA Master Agreement valuation methodology, with supporting footnotes which help explain the suggested variations and highlight other areas the parties may wish to consider.

While most of the definitions are self-explanatory, users of the language should note:

- the “Clearing Deadline” can be set to occur before the actual deadline for mandatory clearing under EMIR. This is: (i) to allow time for the Transactions to be terminated shortly before the actual deadline, to avoid the parties breaching the clearing obligation; and (ii) potentially, to help avoid the market disruption which could occur if the Frontloading ATE is used by a large number of market participants to terminate transactions on or just after the EMIR mandated clearing deadline; and
- where the Clearing Deadline has been set to occur a given number of Local Business Days prior to the actual deadline for mandatory clearing, the parties may want to consider the definition of “Local Business Day” set out in the Frontloading ATE, potentially amending it to suit their circumstances and for further clarity, such as by replacing “the places specified... of the Agreement” with one or more appropriate locations (e.g. “London and New York”).