

When Worlds Collide: An Overview of New Industry Documentation for Cleared Swaps

BY LAUREN TEIGLAND-HUNT¹

Introduction

Many *Seinfeld* fans will recall the angst felt by George Costanza when two of his worlds began to collide (in George's case, his "relationship world" and his "friends world"). Some newcomers to swap clearing may be similarly concerned when they realize that their cleared swaps will not be governed by the familiar, tried and true ISDA master agreement that governs their uncleared swaps; instead they must become comfortable with new industry documentation that has emerged from the collision of the swaps and futures clearing worlds in the United States.² This article is intended to explain the basis for this new documentation and provide an overview of its architecture and contents.

Background

Although Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") has ushered in a variety of significant changes for the swaps industry, swap clearing itself is not new. The London Clearing House³ introduced interest rate swap clearing through SwapClear in 1999, and energy swap clearing was offered by IntercontinentalExchange, Inc. (ICE) as early as March 2002.⁴

What is new, courtesy of Dodd-Frank, is the introduction of *mandatory* clearing requirements. In fact, the U.S. Commodity

Futures Trading Commission ("CFTC") is expected to make its final determination as to the initial categories of swaps that will be required to be cleared in the coming weeks.⁵ The imminent advent of mandatory clearing has led to a flurry of negotiation activity in recent months as market participants strive to put in place necessary swap clearing arrangements in advance of the clearing mandate. In the process, firms familiar with traditional swap market practices are often surprised to learn that the U.S. documentation for cleared swaps relies on futures account agreements rather than ISDA documentation.

One of the reasons for this approach is historical: when swap clearing was first introduced in the United States, futures brokers (i.e., futures commission merchants registered with the CFTC ("FCMs")) that were willing to clear swaps for their customers chose to document these swap clearing arrangements using their pre-existing futures account documentation, subject to a few changes to address some of the unique attributes of swap products. A related reason is

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that, under Dodd-Frank, swap clearing is required to be conducted through FCMs. Specifically, Dodd-Frank’s § 724(a) added a new sub-section 4d(f) to the Commodity Exchange Act that requires entities that clear swaps on behalf of swap customers through a Derivatives Clearing Organization (“DCO”) to be FCMs.⁶

This article focuses on the legal documentation that parties will have to put in place in order to engage in cleared swaps in the United States. Part I of this article will describe the legal documentation currently associated with uncleared swaps. Part II will focus on the documentation governing futures transactions. Part III of this article will see how those two models have merged to produce new documentation standards for cleared swaps. Specifically, Part III will focus on the FIA-ISDA Cleared Derivatives Transactions Addendum and the FIA-ISDA Cleared Derivatives Execution Agreement.⁷

Part I: Uncleared Swap Documentation

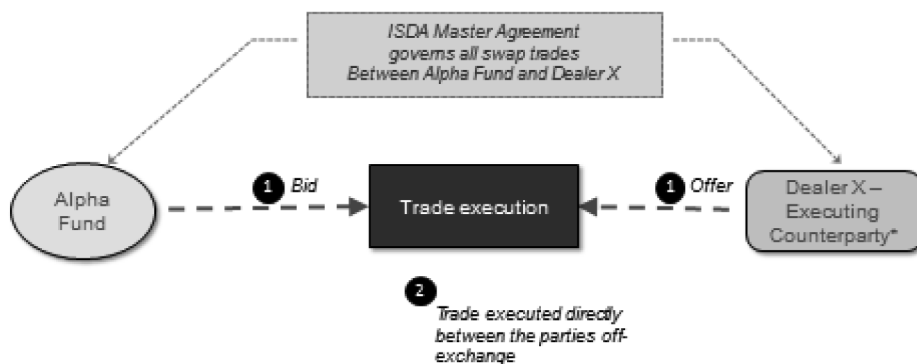
Shortly after the International Swap Dealers Association (ISDA)⁸ was formed in 1985, one of its primary mandates became the development of standardized documentation for the swaps industry. At the time the modern swaps industry was only a few years old, and swaps were generally be-

ing documented as stand-alone transactions under lengthy, bespoke documentation that took a great deal of time to draft and negotiate. ISDA produced its first standardized master agreements for interest rate swaps and currency transactions in 1987. Five years later, ISDA published new versions of its master agreement for swaps, but without limiting their scope to particular products or asset classes. The most recent version of the ISDA master agreement was published in 2002 and similarly is not product-specific.

Although an ISDA master agreement is capable of governing the most complex of swap transactions, the master contract itself is a relatively straightforward principal-to-principal agreement between two parties that is designed to help the parties manage their trading relationship and the credit risk to which they will each be exposed as they enter into transactions with each other over time.⁹ Each individual swap trade that the parties execute with each other is typically evidenced by a separate “confirmation” detailing the economic and legal terms of the particular trade and incorporating the master agreement by reference.

The execution process is also straightforward given that it involves only two parties. Below is a diagram illustrating the execution of an uncleared swap and the governing documentation:

Bilateral (Off-Exchange) Uncleared Swap Execution: Principal-to-Principal Transaction



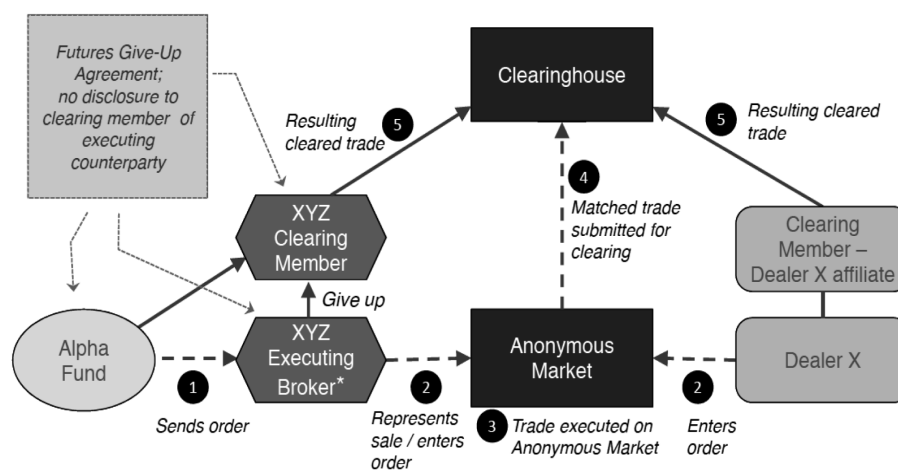
* Here Dealer X is acting as principal at arm's length and is acting in its own interest.

Part II: Futures Documentation

The entry into a cleared transaction like a futures contract involves multiple parties—both at execution and by virtue of the introduction of clearing into the process. The process for establishing a futures contract is more complex as a result, as illustrated in the diagram below.¹⁰ In addition, multiple parties means more contracts, and the fact that these parties are acting in different capacities as compared to parties to master agreements governing uncleared swaps means that the nature of their agreements are different. These contracts are described below.

Execution Arrangement Comparison

Futures Execution: Executing Broker Representation on Anonymous Markets



* Futures "Give-Up" Arrangement: representation of Alpha by Executing Broker to Anonymous Market. XYZ Executing Broker is acting on behalf of Alpha Fund as Alpha's agent. XYZ EB takes Alpha's order to the Exchange and can execute the trade with anyone in the market to secure best price. XYZ FCM does not know identity of trade counterparties.

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will not be evidenced by individual confirmations; rather, they will be set forth in the contract specifications contained in the relevant futures exchange and clearing house rulebooks. These rulebooks also govern the interactions between the executing brokers and other exchange members transacting on the exchange, so there is no need for a separate agreement between them pertaining to execution.

As a result, under the futures market paradigm, there are two key pieces of documentation to be put in place from the perspective of a customer like Alpha Fund:

In the example depicted in the diagram above, the customer, Alpha Fund, is not able to execute a transaction directly because it is not a member of the futures exchange; therefore, it retains an executing broker, as its agent, to execute trades on its behalf in the centralized futures market. After a trade is executed, the trade is submitted to the clearing house for clearing. Once the trade is accepted for clearing, the clearing house agrees to face each of the transacting parties' FCMs on the trade, and Alpha Fund's FCM, which is effectively standing behind Alpha Fund's trade on an agency basis, then passes through the gains and losses on the trade to Alpha Fund pursuant to the bilateral futures clearing agreement between the FCM and Alpha Fund.

Unlike uncleared swaps, the terms of the individual futures contracts executed on behalf of Alpha Fund

The futures clearing agreement. First, there is the futures clearing agreement between Alpha Fund as customer and its chosen FCM, which acts as Alpha Fund's clearing broker. This agreement sets out the terms under which the FCM, as a member of the clearing house that will clear the futures contracts executed by Alpha Fund (through its chosen executing brokers), will accept and stand behind those trades vis-à-vis the clearing house.

Unlike the uncleared swap world, in the United States there is no industry-sanctioned standard form¹¹ of futures clearing agreement; rather, each FCM has its own internal form of clearing agreement. These forms typically address, among other things, margin requirements and other payment obligations, position limits, the grant of security interests in margin and other assets, events of default

and remedies, termination rights, and assignment. Typical negotiation issues include:

- Position limits—provisions addressing the extent to which an FCM can adjust position or credit limits with respect to a customer's trading and the associated prior notice requirements.
- Margin—provisions addressing the amount of margin that the FCM can require from the customer (e.g., clearing house minimums only or a greater amount) and the frequency of and timing for compliance with margin calls (e.g., if a call is made by 11:00 am, customer must post margin that same day; if a call is made later, then customer must post margin next day).
- Events of default and other provisions that give the FCM the right to close out a customer's existing trades.

The "give-up" agreement. Secondly, there is typically a "give up agreement" among the customer, its FCM and each of the customer's chosen executing brokers. For this agreement, an industry standard form does exist and is widely used: the International Uniform Brokerage Execution Services ("Give-Up") Agreement, the 2008 version of which was prepared by the Futures Industry Association ("FIA") in consultation with Managed Funds Association and the Futures and Options Association in the UK. The form itself notes that any changes or additions to its wording must be clearly indicated, and failure to do so constitutes a representation that the document is the standard form as published and has not been modified in any respect.

This triparty give-up agreement serves a number of purposes. For example, it confirms that the executing broker will "give up" all trades it executes on behalf of the customer to the FCM as clearing broker for clearing at the designated clearing house. It also specifies the commissions that will be owed to the executing broker and whether the FCM or the customer will be the party responsible for paying them. Plus this document assigns responsibility to the FCM for paying floor brokerage, exchange or clearing house fees incurred for transactions executed by the executing broker on behalf of the customer.

Part III: Cleared Swap Documentation

The diagram below illustrates the execution and clearing process for a cleared swap and is similar to the futures process in many respects. Like a futures contract, the entry into a cleared swap involves multiple parties. However, one key distinguishing feature is that swaps that are intended to be cleared are typically entered into directly by the parties without the use of executing brokers. As a result, there currently is no need for a triparty, futures-style give-up agreement for cleared swaps. Below we discuss the agreements that are relevant to cleared swaps.

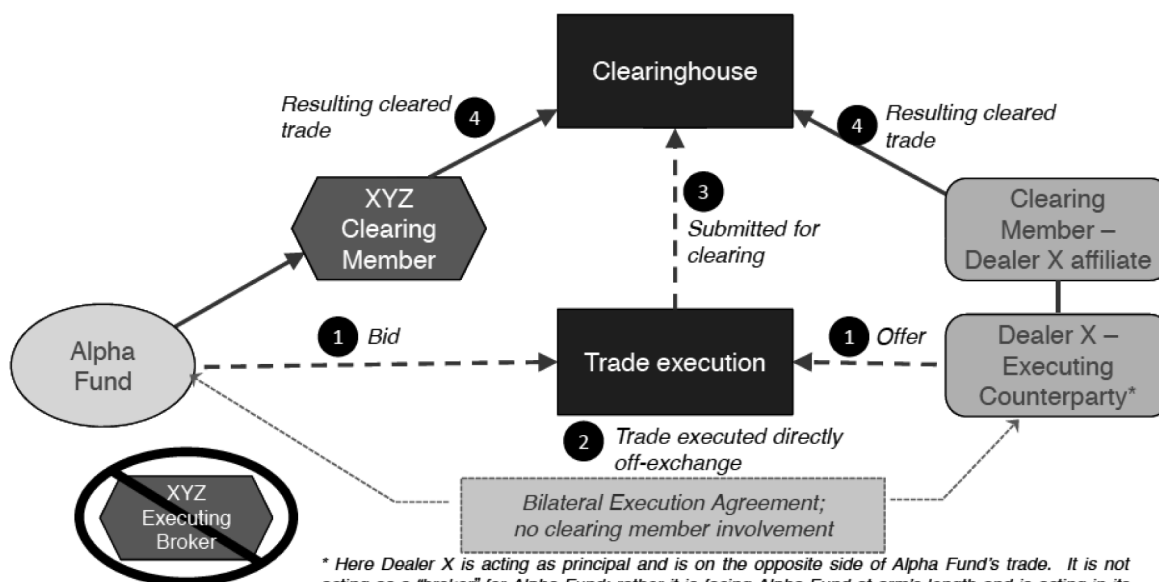
As noted above, FCMs have been relying on their pre-existing futures account documentation to document swap clearing arrangements with their customers since swap clearing was first introduced in the United States over 10 years ago. Many of the FCMs recognized that certain changes needed to be made to their internal forms of futures clearing documentation to take account of the unique attributes of swap products, and over the years several firms had developed their own forms of amendments or addenda to address cleared swaps. With the prospect of more widespread swap clearing on the horizon under Dodd-Frank's clearing mandate, FIA formed an industry working group in late 2010 to develop the first industry standard form addendum for futures clearing agreements to address cleared swaps. Ultimately this addendum was jointly published by FIA and ISDA in August 2012, the details of which are summarized below.

In addition, FIA and ISDA collaborated to develop the industry's first standardized form of "execution agreement" that could be used by parties transacting in swaps that are intended to be cleared. The first version of this document was published in June 2011, and a second version ("Version 1.1") was published in September 2012 in order to address new CFTC rules¹² that were finalized following the publication of the initial version. This document is discussed in more detail below.

FIA-ISDA Cleared Derivatives Transactions Addendum

The FIA-ISDA Cleared Derivatives Transactions Addendum (the "Addendum") supplements the terms of a futures clearing agreement between an FCM and its customer to allow for the clearing of swaps that may be executed by the customer. As noted above, the Addendum is considered necessary because futures agreements typically do not expressly

Bilateral (Non-Exchange) Cleared Derivatives Execution: Anonymity between Clearing Member and Executing Counterparty



* Here Dealer X is acting as principal and is on the opposite side of Alpha Fund's trade. It is not acting as a "broker" for Alpha Fund; rather it is facing Alpha Fund at arm's length and is acting in its own interest. If the trade does not clear (e.g. because either Alpha Fund or Dealer X has exceeded an overall limit imposed by the clearinghouse or imposed by the relevant clearing member), one party may be exposed to credit risk of the other if breakage is owed, so the parties may choose to perform their own credit checks if they have reason to believe that breakage could be material.

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cover cleared swaps, which are distinguishable from futures contracts in certain respects. Because futures clearing agreements are not standardized, it is necessary to review the underlying futures agreement to ensure that the Addendum's terms are drafted appropriately and make conforming changes where necessary (e.g., to make sure defined terms are used consistently). Consequently, most FCMs have adapted the Addendum to work with their internal forms of futures clearing agreements. In addition, customers will often seek to negotiate the terms of the Addendum to suit their needs and objectives.

By its terms the Addendum covers all swaps, forwards, options or similar transactions, whether executed in the OTC market or traded on a Swap Execution Facility ("SEF") or Designated Contract Market ("DCM").¹³ It consists of multiple sections addressing, among other things, various representations and covenants of the FCM and customer with respect to cleared swaps, the consequences of transactions not being accepted for clearing, limita-

tion of the FCM's liability, transfer of positions (i.e., "portability"), liquidation of cleared swaps following a customer default or other close-out event (a "Liquidation Event"), and tax provisions specific to cleared swaps.

Perhaps the most complex section of the Addendum is Section 7, which addresses the liquidation of a cleared swap portfolio following a "Liquidation Event" (which term includes customer defaults and certain tax events). If a Liquidation Event occurs and the Clearing Member (as defined in the Addendum) designates a "Liquidation Date" as a result, the Clearing Member will be required to liquidate customer trades as soon as is commercially reasonable following the Liquidation Date by either entering into offsetting cleared trades in the customer's account or selling the trades to third parties (which may include Clearing Member affiliates if certain conditions are met). If, however, the Clearing Member determines that offsetting or sale transactions are not readily available for certain customer trades

(or the seeking of quotations for such transactions would negatively impact the pricing for the customer's portfolio) or that such transactions would not satisfy a defined "Liquidation Standard",¹⁴ the Clearing Member will be entitled to value such trades in accordance with Section 7(b)(i)(B) of the Addendum and then remove them from the customer's account. The valuation methodology to be applied by the Clearing Member under this provision is similar to the "Close-out Amount" methodology that is used for the valuation of terminated uncleared swap transactions under the 2002 ISDA Master Agreement.

FIA-ISDA Cleared Derivatives Execution Agreement

The FIA-ISDA Cleared Derivatives Execution Agreement (the "Execution Agreement") is a bilateral agreement between the two parties that execute a swap that is intended to be cleared and is unique to cleared swaps. There is no equivalent agreement in the futures world because the terms governing the execution of futures contracts are addressed in the rulebooks of the exchanges on which they are transacted. Interestingly, the energy and rate swap markets operated for over 10 years without the use of an agreement governing the execution of swaps that are intended to be cleared. In many of these markets, clearing house rules provide that, if a trade fails to clear, there will be no trade and no obligations between the executing parties to the trade. However, industry demand for a standardized document addressing certain potential execution issues related to swaps that are intended to be cleared emerged with the prospect of a larger and more diverse cleared swap market in light of Dodd-Frank's clearing mandate. As noted in the memorandum accompanying Version 1.1 of the Execution Agreement, "FIA and ISDA fully expect that as straight through processing and anonymous trading become a reality, the need for breakage agreements [like the Execution Agreement] will lessen over time."¹⁵

The Execution Agreement not only addresses the submission of a swap for clearing but also the procedures and remedies that will apply if a swap fails to clear. Once a swap is accepted for clearing, the swap between the dealer and customer is replaced with two separate cleared swap transactions between each of the parties' respective FCMs and the clearing house, and the Execution Agreement no longer applies.

The Execution Agreement addresses some potential execution issues by: (1) requiring each party

to a swap to represent it has appropriate clearing arrangements in place; (2) requiring each party to assume specific responsibilities in submitting trades for clearing; and (3) specifying remedies to address the possibility of the failure of a trade to clear. Notably, the Execution Agreement provides for the payment of "breakage" between the parties (if elected by "Party A") following the rejection of a trade or the failure of a trade to clear within a specified timeframe. Breakage is calculated based on the 2002 ISDA Master Agreement concept of "Close-out Amount".

Conclusion

Prior to FIA's undertaking its documentation standardization initiative in 2010 for cleared swaps, the industry was contemplating that each clearing house would have its own customer clearing documentation. Such an approach would have required market participants to review and negotiate multiple sets of cleared swap documentation, which could have been tremendously burdensome as the effective date of the clearing mandate approached. Therefore, the recent publication by FIA and ISDA of standardized documentation that can be used for clearing swaps at multiple clearing houses has greatly facilitated market participants' ability to prepare for the clearing mandate and is most welcome—and as the Costanzas would say, "just in time for Festivus."

END NOTES

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2. This article focuses on the documentation being used in the United States for cleared swaps. It should be noted that in Europe certain client clearing models are expected to rely on the potential use of ISDA master agreements to govern cleared swap transactions.
3. The London Clearing House is now known as LCH. Clearnet Ltd.

4. Prior to 1999, the only significant swap clearing was done by OM Stockholm in Sweden for both standardized and tailor-made contracts. See Bank for International Settlements—Committee on Payment and Settlement Systems and the Eurocurrency Standing Committee of the Central Banks of the Group of Ten countries, *OTC Derivatives: Settlement Procedures and Counterparty Risk Management*, Report by the Committee on Payment and Settlement Systems and the Eurocurrency Standing Committee, September 1998, available at <http://www.bis.org/publ/cps27.htm>.
5. Earlier this year the CFTC reviewed submissions from clearing houses and proposed regulations that would require that certain classes of credit default swaps (“CDS”) on broad-based indices and interest rate swaps (“IRS”) be cleared. See CFTC, Proposed Rule, *Clearing Requirement Determination Under Section 2(h) of the CEA*, 77 Fed. Reg. 47170 (August 7, 2012).
6. Section 4d(f)(1) reads as follows: “It shall be unlawful for any person to accept any money, securities, or property (or to extend any credit in lieu of money, securities, or property) from, for, or on behalf of a swaps customer to margin, guarantee, or secure a swap cleared by or through a derivatives clearing organization (including money, securities, or property accruing to the customer as the result of such a swap), unless the person shall have registered under this Act with the Commission as a futures commission merchant, and the registration shall not have expired nor been suspended nor revoked.” 7 U.S.C. § 6(d).
7. Both of these agreements are available as free downloads from FIA’s Web site “<http://www.futuresindustry.org>” and ISDA’s Web site “<http://www.isda.org>”.
8. ISDA later changed its legal name to the International Swaps and Derivatives Association, Inc.
9. As such, the ISDA master agreement sets forth general legal and administrative terms that will apply to all of the swap transactions entered into under it, including terms related to: (i) payment and delivery obligations; (ii) netting of payments; (iii) representations and covenants; (iv) events of default and termination events; and (v) early termination/close-out netting. Although the ISDA Master Agreement is a standardized industry-accepted agreement, its terms tend to be heavily negotiated. Negotiated changes as well as different elections are set out in the Schedule to the ISDA Master Agreement, which typically includes standard terms for the posting of collateral in a “Credit Support Annex”.
10. The second and third diagrams included in this article were both published by FIA and ISDA as materials accompanying the publication of the FIA-ISDA Cleared Derivatives Execution Agreement in June 2011.
11. Standard form futures agreements have been published in the UK by the Futures and Options Association (FOA). Specifically, FOA has developed a “comprehensive set of Client Terms of Business documentation suitable for Eligible Counterparty, Professional and Retail clients. These terms cover a range of products including futures and options and can be used when doing business with clients in a number of different jurisdictions.” These forms are available only to FOA members.
12. See CFTC, Final Rule, *Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management*, 77 Fed. Reg. 21278 (April 9, 2012).
13. With respect to security-based swaps, the Addendum notes, “[t]he extent to which this Cleared Derivatives Addendum will apply to certain security-based swaps, including CDS on narrow-based indices and single names, will depend on the scope of the regulations to be adopted by the Commodity Futures Trading Commission and the Securities and Exchange Commission. This Cleared Derivatives Addendum may have to be revised to reflect those regulatory requirements.”
14. The Addendum provides that “Liquidation Standard” means, “with respect to determining whether and when to take a course of action, and in taking any such course of action, on or following a Liquidation Date, a standard that entails acting in good faith, in accordance with Applicable Law and using commercially reasonable procedures in order to produce a commercially reasonable result; **provided further**, that Clearing Member may effect Close-out Transactions, Risk-reducing Transactions and Mitigation Transactions with Clearing Member or Clearing Member’s affiliates, and an affiliate of Clearing Member may effect a Mitigation Transaction with Clearing Member or another of Clearing Member’s affiliates, only to the extent that such transactions are executed on an arm’s length basis and at then prevailing market prices, as determined in any commercially reasonable manner by Clearing Member; **provided, however**, if Clearing Member, acting reasonably and in good faith, determines there are no relevant prevailing market prices for such transactions at such time or that actively soliciting quotations for such transactions would produce prevailing market prices for such transactions that would not satisfy the Liquidation Standard, such transactions may be executed on an arm’s length basis at a commercially reasonable price.”
15. FIA-ISDA, Memorandum, FIA-ISDA Cleared Derivatives Execution Agreement (September 19, 2012).