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Margin requirements for non-cleared derivatives: final draft published

On 8 March 2016 the final draft of the regulatory technical standards on the requirements under EMIR for margining of non-cleared OTC derivative contracts was published. This follows consultations on the drafts of the regulatory technical standards published by the European Supervisory Authorities on 14 April 2014 and 10 June 2015.

This briefing summarises the main requirements of the proposed rules as well as the key changes from the earlier drafts, and provides insight into the implementation process for market participants. It should be noted, however, that the final draft regulatory technical standards are still subject to adoption by the European Commission and review by the EU Council and Parliament.

The Final Draft RTS

The Final Draft RTS are made under Article 11(3) of EMIR, which requires financial counterparties ("FCs") and non-financial counterparties which exceed the clearing thresholds set out under EMIR ("NFC+s") to have risk-management procedures in place that require the exchange of collateral for OTC derivative contracts not cleared by a central counterparty ("CCP"). The Final Draft RTS apply these risk-management requirements to any OTC derivative contract which was subject to the requirements at its inception.

In summary, the risk-mitigation requirements include:

- a requirement to collect Initial Margin (without offsetting amounts due between the parties) and Variation Margin in respect of OTC derivative transactions that are not centrally cleared;
- a requirement also to post margin where a counterparty established in the European Union (the "EU") enters into an OTC derivative contract with a counterparty which is established in a non-EU country and would be subject to the rules if it were established in the EU;
- certain exemptions and thresholds limiting the requirements to collect margin;
- a requirement to segregate Initial Margin and a restriction on its re-hypothecation;
- rules concerning operational procedures and documentation;
- concentration limits for Initial Margin;
- eligibility criteria for Initial Margin and Variation Margin; and
- details of calculation timing and methodology for Initial Margin and Variation Margin.

Key changes in the Final Draft RTS

- Certain concentration limits relaxed where using the same asset class as the underlying reference asset in the transaction as collateral.
- Concentration limits not applicable to Variation Margin and de minimis exceptions to concentration limits for Initial Margin.
- Segregation of Initial Margin in the form of cash collateral clarified.
- Initial Margin in the form of cash to be held with a central bank or other third-party bank custodian.
- Delays to implementation for FX and equity options.
- For trades between systemically important institutions, no more than 20 per cent of any Initial Margin collected may be in cash held by a single third-party custodian.
- Carve-outs where posting collateral to jurisdictions in which netting and segregation may not be effective.
- Timing for margin calculations clarified.
- Legal reviews of netting and segregation can be conducted internally, can rely on the Capital Requirements Regulation ("CRR") netting reviews, and no longer need to be repeated annually.
- Clarification of interaction with non-EU rules where a counterparty is domiciled in a third (non-EU) country.

What is Initial Margin and Variation Margin?

Initial margin ("Initial Margin") is collateral collected by a party to cover its current and potential future exposure in the interval between the last exchange of margin and (i) the liquidation of positions following the default of its counterparty or (ii) the hedging of that exposure (the "Margin Period of Risk" or "MPOR"). In the ISDA Credit Support Annex, Initial Margin is represented by the "Independent Amount".

Variation margin ("Variation Margin") is collateral collected by a party on a regular basis to reflect changes in market value of relevant outstanding contracts.

Opt-outs and exclusions based on thresholds

Opt-out for NFC-s

In relation to both Initial Margin and Variation Margin, the risk-mitigation procedures of FCs and NFC+s may provide that no Initial Margin or Variation Margin is required for trades with non-financial counterparties (as defined in EMIR) which do not exceed the clearing threshold set out under EMIR ("NFC-s") or with entities which would be NFC-s if they were established in the EU.

This means that, for instance, repackaging, CLO and other securitisation vehicles outside the EU should, as NFC-s, be able to agree collateral requirements with their swap providers that meet rating agency criteria – such as one-way posting of collateral by the swap provider to the vehicle – rather than the new rules. However, in order for the vehicle to take advantage of this opt-out, the notional amount of OTC derivative transactions entered into by the vehicle and the other NFC-s within its group will have to remain at all times below the applicable clearing thresholds. This should be possible, as, unlike other thresholds used in the Final Draft RTS (explained below), the clearing thresholds exclude eligible hedge transactions from the calculation of the threshold notional amount.

Notional Amount Threshold

FCs and NFC+s may provide in their risk-management procedures that Initial Margin is not collected for new contracts from January of each year where one of the counterparties has, or belongs to a group which has, an average month-end aggregate notional amount of non-cleared derivatives for the months March, April and May of the preceding year which is below EUR 8 billion (the "Notional Amount Threshold").

When applying the Notional Amount Threshold, the notional amounts of all non-cleared OTC derivative contracts, including with counterparties which are permanently or temporarily exempted or partially exempted, should be included in the calculation of the aggregate notional amount. These will include physically settled FX options and swaps, currency swaps, swaps with covered bond vehicles, contracts subject to the opt-outs and exempted intragroup contracts (the latter being taken into account only once).

For the purpose of assessing the Notional Amount Threshold for an investment fund, the Final Draft RTS acknowledge that investment funds should be treated as a special case because management by a single manager could improperly capture them in a single group. Consequently, the Final Draft RTS provide that a fund may be treated as a distinct entity and treated separately for the purposes of applying the Notional Amount Threshold where such fund (i) comprises "a distinct pool of assets" for the purposes of treatment on insolvency or bankruptcy and (ii) is not collateralised, guaranteed or otherwise supported by other investment funds or the investment managers – even if the fund is under common management with other funds.

IM Transfer Threshold

The Final Draft RTS state that the risk-management procedures of FCs and NFC+s may provide that no Initial Margin need be collected where the counterparties are unconnected and the amount of Initial Margin otherwise required to be collected by all parties in the collecting group from all parties in the posting group (or by individual parties, if neither party is part of a group) for all non-cleared OTC derivatives would be equal to or less than EUR 50 million (the "IM Transfer Threshold"). Where the counterparties are part of the same group, the IM Transfer Threshold reduces to EUR 10 million. Where Initial Margin to be collected exceeds the IM Transfer Threshold, the amount of Initial Margin to be collected may be reduced by the relevant threshold amount.

In calculating the IM Transfer Threshold for an investment fund, the same treatment applies as for the Notional Amount Threshold explained above.

Minimum transfer amount

FCs and NFC+s can also provide in their risk-management procedures that no collateral (whether Initial Margin or Variation Margin) need be collected

from a counterparty where the amount due from that counterparty would be equal to or less than EUR 500,000 (or its equivalent in another currency) across all relevant transactions (the "Minimum Transfer Amount"). The Minimum Transfer Amount is assessed on a per-transfer basis, to be calculated by reference to the previous collection of collateral. Parties can agree a lower amount than EUR 500,000, but that figure is the maximum permitted. If the amount due exceeds the Minimum Transfer Amount, the full amount must be transferred.

It is questionable whether a sub-fund may be treated as a distinct counterparty with its own separate Minimum Transfer Amount if it forms part of the same legal entity as any other fund or sub-fund, given that the clarification wording in relation to "distinct pools of assets" that is used in connection with the Notional Amount Threshold and IM Transfer Threshold provisions is not used in the Minimum Transfer Amount provisions.

Other opt-outs and exclusions

The Final Draft RTS also include the following opt-outs and exclusions:

FX

Counterparties' risk-management procedures may provide that no Initial Margin is required on physically settled FX forwards and swaps or on the exchange of principal and interest in currency swaps. There is no such flexibility for interest rate swaps or other types of derivatives.

Covered Bonds

Counterparties entering OTC derivatives with covered bond issuers can include in their risk-management procedures that such issuers are not required to post either Initial Margin or Variation Margin provided that certain structural protections for the hedge counterparties are built into the transaction. No such option is provided for trades with securitisation vehicles such as CLOs, or for repackaging vehicles. However these issuers will usually fall below the Notional Amount Threshold, and will instead be able to rely on their swap counterparty not collecting Variation Margin on the basis of the issuer being an NFC-.

The Proposed EU Commission Regulation on Securitisation, published in September 2015, does however provide for an amendment to the Level 1 text of EMIR, to disapply the requirement to collect Initial Margin or Variation Margin from securitisation special purpose vehicles that meet certain criteria, as well as covered bond issuers. This proposed regulation is currently expected to come into force at some point in late 2016 or early 2017.

Note that covered bond issuers will still be required to collect Variation Margin from their counterparty in cash, and must return any collected amounts when no longer due.

CCPs

Counterparties' risk-management procedures can provide that no Initial Margin or Variation Margin is collected in relation to derivative contracts used by a CCP to hedge the portfolio of an insolvent clearing member.

It should be noted that the above opt-out provisions are not automatic exemptions, but are expressed as permissions for the collecting party to have risk-management procedures which allow it not to collect collateral in these circumstances. There is no requirement for any such opt-out to be included in the agreement with the Counterparty, although in practice FCs and NFC+s may choose expressly to agree with their counterparties to use the opt-outs where available or to apply different collateral terms.

Indirectly cleared transactions

Indirectly cleared transactions are subject to CCP margin requirements and are therefore out of the scope of the requirements of the Final Draft RTS.

Exempt contracts where premium is paid upfront

The Recitals to the Final Draft RTS state that, where a netting set consists solely of OTC derivative contracts that imply the payment of a premium upfront to guarantee the performance of the contract, the counterparty receiving the payment of the premium (the option seller) has no exposure if the counterparty paying the premium defaults. Therefore, in these circumstances, it appears that the option seller can choose not to collect additional Initial Margin or Variation Margin for these types of contracts as long as it is not exposed to any credit risk. The option buyer should continue to collect both Initial Margin and Variation Margin. However, this provision is not included in the substantive text of the Final Draft RTS, and the requirement that the netting set consists solely of such contracts may mean that its use is limited.

Delayed application to physically settled FX forwards

As noted above, counterparties may agree not to collect Initial Margin on physically settled FX forwards and swaps, or the principal in cross-currency swaps, but will be required to post and collect the Variation Margin for these contracts. However, as in the EU there is currently no uniform definition of physically settled FX forwards, the Final Draft RTS provide for a delayed application of the requirement to exchange Variation Margin for physically settled FX forwards, until the earlier of (i) the date of entry into force of the delegated act under the Markets in Financial Instruments Directive (MiFID II), which is expected to enter into force on 3 January 2018 and which will define these contracts, and (ii) 31 December 2018.

Delayed application to equity options

The Final Draft RTS also delay application of the rules to single-stock equity options or options on equity indices until three years after the rules enter into force. This is due to uncertainty as to whether these products will be subject to margin requirements in other jurisdictions and is intended to avoid regulatory arbitrage.

The rules do not prescribe how OTC derivative contracts subject to delayed implementation should be treated where they are part of the same netting set as other OTC derivatives which are within scope of the rules as soon as they come into force. Counterparties could agree bilaterally that these types of derivatives should nevertheless be included in the margin model under the same netting set as though they were subject to the requirements in the Final Draft RTS, or they could treat them separately without having to comply with the rules. It should still be possible to take the latter route without compromising the netting set on a default, if such trades are covered by the same master agreement.

Concentration limits and eligible collateral

Eligible assets

Assets eligible for use as collateral include cash, gold, gilts, debt securities issued by certain public entities, bank bonds including covered bonds, senior securitisation bonds, equities included on a main index (and related convertibles) and units in UCITS. Each category is subject to various credit quality thresholds. Eligible collateral must not include significant wrong-way risk (i.e. positive correlation with the creditworthiness of the counterparty) so collateral cannot consist of securities issued by the posting party or any member of its group.

Haircuts

Collected collateral is also subject to haircuts, either on the basis of standard discounts set out in the Final Draft RTS or by own estimates based on prescribed requirements. The standard haircuts are based on rating, residual maturity and type of collateral and range from 0 per cent for cash and 0.5 per cent for highly rated government debt with less than a year to maturity, to 24 per cent for securitisation positions with a five-year residual maturity and a rating between A+ and BBB-.

Concentration Limits

The concentration limits for Variation Margin have been removed in the Final Draft RTS, and the limits now apply only to assets transferred as Initial Margin.

With respect to Initial Margin, the Final Draft RTS include a limited relaxation of the application of the concentration limits set out in the second draft RTS (the "Second Draft RTS"). The ten per cent limit on Initial Margin from an individual counterparty constituted by corporate bonds or equities of the same issuer (or group) has been changed to the greater of fifteen per cent and EUR 10 million or its equivalent in another currency, but this limit now also applies to securities issued by credit institutions or investment firms (which were omitted from the concentration limits in the Second Draft RTS).

There remains a limit of 40 per cent, (but now subject to a threshold of EUR 10 million, if greater, or its equivalent in another currency) on, cumulatively, certain (i) equities issued by institutions subject to the CRR (i.e. banks and certain investment firms), (ii) convertibles issued by such institutions, and (iii) securitisation positions, in each case including where those assets are included in a UCITS.

These new EUR 10 million thresholds will mean greater flexibility for smaller transactions.

A carve-out from the scope of the concentration limits applies to collateral consisting of central government debt, certain other public sector debt and the debt securities of certain multinational development banks and other international organisations (although the requirement that other public sector debt must be guaranteed in order to fall within the carve-out has been removed). For these instruments a 50 per cent single-issuer concentration limit applies but only to contracts entered into between global and other systemically important institutions, or individual

counterparties collecting from an individual counterparty if the Initial Margin to be collected is in excess of EUR 1 billion, and in either case the concentration limit is only applied to the collateral collected in excess of EUR 1 billion. The aim of this carve-out is to allow smaller market participants to continue using solely sovereign debt as collateral and to require only systemically important institutions (as identified in the Capital Requirements Directive) ("SIIs") and entities with large OTC derivative portfolios and more sophisticated trading strategies to diversify such collateral.

The 50 per cent limit on assets from a single issuer is also expressed to apply to the risk exposures arising from third-party holders or custodians holding Initial Margin collected in cash. This appears to mean that no more than 50 per cent of Initial Margin in the form of cash and any re-invested cash above EUR 1 billion may be held with one custodian or custodians domiciled in the same country, although this provision is not very clear. In addition, where SIIs collect Initial Margin in cash from a single counterparty that is also a SII, the collecting counterparty has to ensure that not more than 20 per cent of that Initial Margin is held in cash by a single third-party custodian.

The concentration limits in the Second Draft RTS were overly prescriptive with regard to certain specific scenarios in which diversification could worsen rather than improve the protection provided by collateral. For example, it is common for an equity derivative transaction to be collateralised by taking security over the reference shares underlying the transaction, such that the collateral perfectly matches the exposure. Imposing a concentration limit here actually makes the collateral less effective at covering the exposure. The Final Draft RTS remove this issue by allowing the collecting counterparty to disapply the diversification requirements above where collateral is collected in the form of an asset class which is the same as the underlying asset class of the contract.

Segregation

The Final Draft RTS require collateral collected as Initial Margin to be segregated as follows:

- where the collateral is a proprietary asset of the collecting counterparty, it must be segregated from the other proprietary assets of the collecting party;
- where the collateral is not a proprietary asset of the collecting party, it must be segregated from the proprietary assets of the posting party; and
- in all cases, it must be segregated from the proprietary assets of the third-party holder or custodian (the "Account Bank").

The collecting counterparty or the Account Bank must also give the posting party the option for its Initial Margin to be individually segregated from that of other posting parties.

"Segregation" in each case must be effected either on the books and records of the Account Bank or via other legally binding arrangements, "so that the Initial Margin is protected from the default or insolvency of the collecting counterparty", but no additional detail is given as to the legal structure by which this should be achieved.

Collateral which is a proprietary asset of the collecting party

The requirement on the collecting counterparty to segregate collateral which is a proprietary asset would appear to require that collateral is (i) held with a custodian in an account separate from any account containing other proprietary assets of the collecting party and (ii) legally ring-fenced in the event of the collecting party's insolvency. Methods for achieving this ring-fence could include subjecting such accounts to a trust or security interest in favour of the posting party. These requirements mean that the collecting party would lose some of the advantages of a full title transfer, including the ability to dispose of or deal with the collateral for its own account. In order to benefit from close-out netting provisions the collateral arrangement would need to be structured to ensure that a title transfer takes place in favour of the collecting party, given the requirement for collateral to be held separately from the collecting party's own assets and ring-fenced on an insolvency.

Collateral which is not a proprietary asset of the collecting party

Where collateral is not a proprietary asset of the collecting party, segregation from the assets of the posting party could be achieved by holding it in a custody account with either the collecting party as custodian or with an Account Bank. The account would need to be in the name of or for the benefit of the posting party and separate from any other proprietary custody account in the name of the posting party. A security interest over the collateral would also need to be created in favour of the collecting party in order that the collecting party would be entitled to dispose of or appropriate the collateral on a default or insolvency of the posting party.

The Final Draft RTS also contain a requirement that Initial Margin is available to the posting party in a timely manner on the default of the collecting party. In practice, however, all collateral arrangements which do not involve title transfer will require the collecting party to be granted an effective security interest over the collateral. Such a security interest will typically be structured to constitute a financial collateral arrangement in compliance with local law implementation of the 2002 EU Financial Collateral Directive, in order to give the collateral taker immediate access to the collateral without the need for the consent of any administrator of the defaulting entity, and without having to obtain a court order (at least in relation to EU jurisdictions). It is unclear whether a requirement that the collateral be available to the posting party in this way would be consistent with the requirement under the Directive for the collecting party to have possession or control over the collateral.

Furthermore, this requirement does not reflect usual market practice on default of the collecting party because ordinarily such a default does not automatically release security. The collecting party may be the party owed a net termination payment under the master derivative documentation, therefore the security would usually remain in place until sums owed are paid. It may be that the intention is to require release of collateral back to the posting party only once it has discharged its obligations under the secured transactions, although this is not made clear. The ESAs have kept the emphasis on protecting the posting party rather than alleviating the issues this presents for title transfer and security arrangements.

Cash Collateral

The Final Draft RTS have removed the requirement that cash posted as Initial Margin should be segregated on the same basis as other collateral, acknowledging that this is operationally difficult. Instead, there is a new requirement that cash collateral posted as Initial Margin must be held in accounts maintained at central banks or an Account Bank which is a credit institution authorised under the CRR (which appears to rule out the use of non-EU credit institutions as Account Bank). The Account Bank should not belong to the same group as either of the counterparties. The collecting party is required to take into account the credit quality of the Account Bank but without "solely or mechanistically" relying on external ratings. It appears that such transfers could operate on a title transfer basis, so that such amounts could be applied in any netting or set-off calculations under the relevant master agreement upon a default or insolvency of either party. The provisions still appear to require that the cash is held in such a way as to be available to the posting counterparty on a timely basis in the event of the default of the collecting counterparty (see "Collateral management requirements" below), although it is not made clear how this is to be achieved. However, cash collateral will remain open to the risk of default of the custodian (although the 50 per cent and 20 per cent limits described in "Concentration Limits" above go some way towards mitigating this risk where the counterparties in question are SIIs or for larger collateral exposures).

The Recitals suggest that cash collateral posted as Initial Margin may be re-invested where a credit institution is not able to segregate cash collateral and to that end re-investment of cash by a third-party custodian is exempted from the prohibition on re-use of collateral (see "Ban on re-hypothecation" below).

Legal review of effectiveness of segregation

The Final Draft RTS have confirmed that an external legal opinion on the effectiveness of the segregation arrangements is not necessary. Although an "independent legal review" is required to confirm that the segregation arrangements meet the above requirements, this may be carried out either by an external third party or by an independent internal unit. On request of the competent authority, counterparties must also provide documentation supporting the effectiveness of segregation in each relevant jurisdiction and set up policies ensuring continuous compliance.

Where the legal review highlights possible non-compliance with the requirements for enforceable segregation arrangements, the requirements set out in Non-Netting jurisdictions below will apply.

Ban on re-hypothecation

The Final Draft RTS confirm that the collected Initial Margin may not be re-hypothecated, re-pledged or otherwise re-used. This ban will have a restrictive effect on liquidity as it will prevent the collateral taker from re-using the collateral for other purposes such as repo or securities-lending transactions. However, there is a carve-out for the re-investment of cash collateral. The Second Draft RTS contained strict limits on the re-investment of cash, but curiously these provisions have been deleted in the Final Draft RTS. Nevertheless, the Recitals state that a credit institution should be allowed to re-invest cash posted as Initial Margin where it is "not able" to segregate cash collateral.

Calculation of margin and modelling

Collection of Initial Margin is to be made without offsetting the Initial Margin amounts due from each counterparty to the other.

In order to calculate Initial Margin, counterparties may use either the standardised approach set out in the Final Draft RTS or an Initial Margin model, or both (although where both are used, the total Initial Margin requirement for the netting set will be the sum of the amounts calculated under the two models). The characteristics of any Initial Margin model and the data to be used must be agreed with the other counterparty to the trade. The rules do allow counterparties to use different models from each other, although this may prove to be impractical. The standardised approach is likely to be less flexible and require more collateral in general than a bespoke Initial Margin model.

ISDA has been working on an Initial Margin model (ISDA SIMM™) with the aim of creating an industry-standard Initial Margin Model for use by all market participants and has published provisional documentation on its website. ISDA has discussed ISDA SIMM™ with regulators and has launched a licensing program for service providers to acquire the right to use ISDA SIMM™. The hope is that this will create a single framework for licensed counterparties to calculate Initial Margin, thereby reducing the potential for disputes and facilitating swift resolution where disputes do arise.

Collateral management requirements

A party collecting collateral must have certain risk-management procedures with respect to collected margin in place. These must ensure:

- the daily re-evaluation of collateral assets;
- the establishment of legal arrangements which allow access to collateral if held by a third-party custodian;
- the holding of Initial Margin in insolvency-remote custody accounts if held with the collateral provider;
- the maintenance of cash accounts with a central bank or third-party credit institution authorised under CRR for the holding of Initial Margin in cash;
- that unused collateral can be made available to the insolvency official of the defaulting party;
- that, in the event of default of the collecting counterparty, the Initial Margin is freely transferable in a timely manner back to the posting party; and
- that non-cash collateral is transferable without any regulatory or legal constraints or third-party claims, including those of a liquidator or the collecting counterparty or custodian, other than liens for fees and expenses incurred in providing the custody account or otherwise routinely imposed by clearing systems in which the collateral is held.

The requirement for daily re-evaluation may mean a change in practice in some markets, such as the longevity swaps market, where current practice does not require daily margin valuation as the underlying asset is not traded in a liquid market.

Netting enforceability

The Final Draft RTS require that counterparties conduct an "independent legal review" in order to verify the legal enforceability of the relevant bilateral netting arrangements and must always be able to provide documentation supporting the legal basis for compliance of the arrangements in each jurisdiction. The requirement in the Second Draft RTS that this legal review be conducted annually has been removed, as the ESAs have recognised the operational burden of doing so. However, counterparties must set up policies ensuring the continuous assessment of compliance.

As we suggested in our previous briefing, the Final Draft RTS clarify that this legal review may be conducted by an internal independent unit, or by an external independent third party. The legal review will be considered to have been performed for netting agreements that have been recognised in accordance with Article 296 of the CRR (i.e. for recognition of reduction of counterparty credit risk).

Non-netting jurisdictions - collateral-free limits

The Final Draft RTS provide that where the legal enforceability of a netting agreement in a third-country jurisdiction (a "non-netting jurisdiction") cannot at all times be confirmed, or where the legal review of the effectiveness of the segregation of Initial Margin concludes that no segregation arrangement with the counterparty in a third-country jurisdiction can meet the requirements of the rules:

- a counterparty does not need to post any Variation Margin or Initial Margin for OTC derivatives with counterparties domiciled in that jurisdiction but should still be required to collect margin from those counterparties; and

- there is no requirement for a counterparty to collect or post Variation Margin or Initial Margin if the ratio of:
  (i) the notional amount outstanding of OTC derivative contracts of its group for which no margin is collected from such third-country counterparties; to

  (ii) the total notional amount outstanding of OTC derivative contracts of its group,

  is less than 2.5 per cent.

The ESAs note that credit institutions are, however, required to hold capital on a gross basis for derivatives concluded with parties in a non-netting jurisdiction, as the netting agreement will not be recognised for regulatory capital purposes.

Trading documentation

The Final Draft RTS require the trading relationship between parties to be documented prior to or simultaneously with the entry into of non-cleared OTC derivative transactions, regardless of whether the parties are required to exchange margin. The documentation must include terms covering:

- payment obligations;
- payment netting;
- close-out netting;
- events of default;
- calculation methods; and
- governing law.

Intragroup transactions

The Final Draft RTS include detailed criteria which must be met for a group to obtain the exemption under Articles 11(6) to 11(10) of EMIR from posting margin for intragroup transactions where there are no practical or legal impediments to the transfer of own funds and repayment of liabilities. These practical or legal impediments may include currency and exchange controls, restrictions in the counterparties' constitutional documents, the existence of minority interests, or any of the conditions for resolution action to be taken under the Bank Recovery and Resolution Directive.

Where one of the two counterparties in the group is domiciled in a third country for which an equivalence determination under Article 13(2) of EMIR has not yet been provided, Variation Margin and Initial Margin must be exchanged for all intragroup transactions with subsidiaries in that third country. However, as is the case with similar requirements relating to clearing obligations under EMIR, the Final Draft RTS delay the implementation of this requirement for up to three years to allow enough time to complete the equivalence process.

Grandfathering and phase-in

Whilst there appears to be no substantive provision in the Final Draft RTS which provides for grandfathering existing OTC derivative contracts, the Recitals state that the rules will only apply to new contracts entered into after the relevant phase-in dates. Parties to OTC derivative contracts entered into before those dates will need to choose whether to amend their existing documentation to apply the new rules across all of their OTC derivative contracts with a counterparty or enter into new documentation to apply the new rules only to new trades. The Final Draft RTS do not prescribe how the rules are expected to apply to a netting set within which a portion of the individual OTC derivative contracts are entered into prior to the relevant phase-in date and the remainder are entered into thereafter. Parties may opt to create a new netting set by entering a new master agreement governing OTC derivative contracts to which the new rules apply.

Initial Margin requirements and Variation Margin requirements are each phased in on a different, staggered, timetable. Initial Margin requirements are phased in over five years. If both parties have, or belong to groups each of which have, an average notional amount of non-cleared OTC derivatives over EUR 3 trillion on 1 September 2016 they will be required to exchange Initial Margin. The Initial Margin Threshold falls over five years, until reaching EUR 8 billion on 1 September 2020. Variation Margin requirements take effect on 1 September 2016 for the largest counterparties by OTC derivatives trading volume (those over EUR 3 trillion in average notional amount), and from 1 March 2017 for all other counterparties.

As mentioned above, Initial Margin and Variation Margin are not required to be exchanged in respect of (i) FX forwards until the earlier of the date of entry into force of the Commission delegated act to be made under MiFID II and 31 December 2018, and (ii) equity options until the date falling three years after the Final Draft RTS come into force. For exempt intragroup contracts with third-country counterparties, Initial Margin and Variation Margin are not required to be exchanged until three years from the date the Final Draft RTS come into force, where there is no equivalence decision under EMIR. Where an

equivalence decision has been adopted, the requirements to exchange margin will take effect on the later of sixty days from adoption and the relevant phase-in date mentioned above.

Applications for intragroup exemptions under Article 11 of EMIR can be made from the later of the date the Final Draft RTS come into force and six months before the date of application of Variation Margin requirements to the relevant counterparty, and decisions on such applications are to be made within three months. As the Final Draft RTS are unlikely to come into force much before the first counterparties are required to post Variation Margin, these dates may be academic.

The Final Draft RTS do not include a separate phase-in of the eligibility requirements for assets posted as collateral, and thus ISDA documentation will need to provide for the new eligibility requirements by 1 September 2016, being the date the Initial Margin requirements come into force for the largest counterparties.

Interaction of the rules with non-EU regimes

A new provision in the Final Draft RTS is aimed at removing some of the inconsistencies between international rules for the margining of non-cleared derivative transactions. This extends the scope of contracts caught by the rules to contracts which do not fall within the EMIR definition of OTC derivatives. Where a counterparty is domiciled in a third country using a definition of OTC derivative contracts that is different from that used in EMIR, counterparties must calculate margin for all contracts that fall within either the EMIR definition of OTC derivative contract or the definition used in the third country provided that the counterparty domiciled in the third country is subject to margin requirements. For the purposes of calculating the margin, where a netting agreement is in place between two counterparties, one of which is domiciled in a third country, that agreement has to meet the same conditions that it would if both counterparties were domiciled in the EU.

The ESAs explain that this provision prevents the parties having to double-count to take into effect the differing scope of products within margin requirements in different jurisdictions, whilst also preventing the possible reduction of margin exchanged due to the omission of regulated derivative contracts or inclusion of other products.

Furthermore, the first draft RTS were drafted on the assumption that counterparties in equivalent third-country jurisdictions would also be required to collect margin, so no express provision was made requiring EU counterparties to post margin to such non-EU entities. However responses to the consultation on the first draft noted that third-country rules may not always mirror the EU requirements in relation to collection of margin. As a result, to avoid EU counterparties being at a competitive advantage in not being required to post margin to non-EU entities in equivalent jurisdictions, the Final Draft RTS provide that Initial Margin and Variation Margin must be exchanged with non-EU entities who would be subject to the requirements if they were established in the EU.

What do firms need to do to prepare?

Credit support documentation

In the immediate future, various terms of existing credit support documentation will require modification, including eligible collateral, collateral haircuts, timing of calculation, and collection and dispute resolution provisions.

As the Initial Margin requirements are phased in, there is likely to be a move away from title transfer arrangements and towards security arrangements, given the requirement to ensure that an entity posting Initial Margin is sufficiently protected in the event of the insolvency of the collecting counterparty.

Working groups coordinated by ISDA have been developing documentation to comply with the new requirements. Documents in development include:

- a new form of English law Credit Support Deed ("CSD") for Initial Margin;
- a new form of English law Credit Support Annex ("CSA") for Variation Margin;
- a self-disclosure form that will be available through ISDA Amend; and
- a Protocol which will update Credit Support Annexes to comply with the requirements in relation to Variation Margin.

ISDA is also aiming to allow for equivalent rules in the US and Japan to be incorporated consistently by market participants without the need for individual re-negotiation of ISDA master agreements and CSAs.

For any one trading relationship, many market participants will aim (i) in respect of Variation Margin, to retain their existing CSA for legacy transactions and to implement a new CSA for EMIR compliance in respect of new transactions and (ii) in respect of Initial Margin, to implement a new CSD for EMIR compliance

and possibly to create a new CSA for bilaterally agreed Initial Margin for new transactions before phase-in of the Initial Margin requirement.

Custody arrangements

In order to segregate Initial Margin, counterparties will need to set up new accounts with third-party custodians and tripartite custody agreements or account control agreements, together with the associated systems and processes to provide for the exchange and settlement of collateral.

Initial Margin models

Counterparties intending to use bilaterally agreed Initial Margin models will need to implement a model which complies with the detailed requirements of the Final Draft RTS. These requirements cover the confidence interval and risk horizon, the calibration of the model, diversification and hedging, integrity of the approach to risk capture, and measures covering internal governance and audit of the model.

Next stages in the legislative process

The Final Draft RTS will now be considered by the European Commission pursuant to EMIR Article 11(15). The Commission has three months from receipt to decide whether or not to endorse the Final Draft RTS. If it decides not to endorse the draft, or to endorse the draft with changes, the ESAs will then have a further six weeks to resubmit the draft to the Commission for endorsement, in the form of a formal opinion to the Commission. The Commission can then either adopt the amended draft or reject it and adopt a version consistent with the amendments it requested.

Once the Final Draft RTS have been adopted, Parliament and the Council will have a window of one month to veto the final draft, although this period is longer if the Commission adopts a version which differs from the ESAs' draft. Once that window closes, the adopted Final Draft RTS will be published in the Official Journal of the European Union and enter into force 20 days thereafter. This means that if there are no changes made by the Commission, we can expect the Final Draft RTS to come into force in June or July 2016. The phase-in dates are not expected to be postponed, so there will be only a short time (around two to three months for the largest counterparties) between publication in the Official Journal and the start of mandatory margining for the largest counterparties.

International standards

The Final Draft RTS state that they are fully aligned with the BCBS/IOSCO Margin Framework. However, the ESAs continue to follow the work of the expert group that the BCBS and IOSCO set up to monitor the implementation of the margin framework in various jurisdictions. There may, therefore, be further changes to these requirements in the future.

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