Banking / Capital Markets

The Delta Report

Derivatives Newsletter

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In this second issue of The Delta Report for 2017, we cover crucial updates in the derivatives market in Europe and also globally with respect to developments in margining for non-cleared derivatives. In the UK, Brexit continues to dominate the headlines while the negotiating positions of Britain and Europe become clearer. We have also provided in this issue a summary of the landmark constitutional judgment by the UK Supreme Court (handed down in January 2017) as relating to the government's ability to exercise its prerogative powers.

The key topic that remains at the forefront of all derivatives users' minds globally is of course margining. In this issue of the Delta Report, we have sought to provide readers with a summary of the progress on implementing the margin rules across key G20 jurisdictions. In Europe, with some uncertainty remaining around key elements of the rules, we have also provided an in-depth look at Article 30 of such rules (the covered bond exemption).

Other important topics considered include Article 55 and the ISDA 2016 Bail-in Article BRRD Protocol and an update on the now looming implementation of MiFID II/ MiFIR.

Variation Margin Requirements Relief

According to the original timetable, the first implementation date in various G20 countries for uncleared over-the-counter ("**OTC**") derivative variation margin requirements was 1 September 2016 for the largest market participants and the second implementation date was scheduled to be 1 March 2017 for all other market participants. However, as 1 March 2017 approached, there was a recognition by regulators that some market participants would not likely be in a position to fully comply with the variation margin requirements by 1 March 2017. Among other things, market participants indicated that they were facing difficulty in completing the necessary credit support documentation and operational processes to settle variation margin in accordance with the applicable requirements, notwithstanding their efforts to do so.

In light of this, regulators in the US, the European Union, Japan, Hong Kong, Singapore and Australia, among others, have granted relief to market participants to provide them some flexibility in complying with the 1 March 2017 variation margin requirements with respect to certain counterparties. This relief is intended to prevent disruption to the uncleared OTC derivatives market, the occurrence of which would likely undermine the regulatory purpose of the variation margin requirements.

Jurisdiction	Regulator	Relief	Links
United States	Board of Governors of the Federal Reserve System Department of the Treasury (the Office of the Comptroller of the Currency)	Each Swap Dealer that was required to comply with the variation margin requirements on 1 March 2017 with respect to its counterparties is expected to comply with such requirements: • on 1 March 2017 (as scheduled) with respect to its counterparties that present significant exposures as at such time; and • as soon as possible, and in no case later than 1 September 2017, with respect to its other counterparties, provided the Swap Dealer is using good faith efforts to comply with the variation margin requirements by such date. The regulators, in exercising their supervisory discretion, will prioritise compliance efforts by Swap Dealers subject to their jurisdiction based on the size and risk inherent in the credit and market exposure presented by each counterparty.	White & Case Client Alert SR 17-3 OCC Bulletin 2017-12 Press Release
	Farm Credit Administration Federal Deposit Insurance Corporation Federal Housing Finance Agency	Not applicable, as there are no Swap Dealers regulated by such entities that would be affected.	Press Release
	Commodity Futures Trading	Each Swap Dealer that was required to comply with the variation margin requirements on 1 March 2017 with respect to its counterparties must comply prior to	White & Case Client Alert

	Commission	1 September 2017, subject to the following requirements: • the Swap Dealer's current non-compliance with respect to a particular counterparty is solely because it has not, despite good faith efforts, completed necessary credit support documentation or, acting in good faith, requires additional time to implement operational processes to settle variation margin; • the Swap Dealer uses its best efforts to continue to implement compliance without delay; • the Swap Dealer must continue to post and collect variation margin in accordance with any existing arrangements. Swap Dealers are expected to make continual, consistent, and quantifiable progress toward compliance with the variation margin requirements with all counterparties on a rolling basis during this period.	CFTC No-Action Letter 17-11
European Union	European Supervisory Authorities (ESAs)	The ESAs issued a statement noting that the implementation of variation margin requirements by 1 March 2017 "*mainly [posed] a challenge for smaller counterparties*" (i.e. smaller FCs on the buy-side of the market and NFC+s). Taking this into account, it noted that, although the ESAs still expect Competent Authorities (being the relevant regulator in each EU Member State) to generally apply their risk-based supervisory powers to enforce applicable legislation, in this context they may take into account: • the size of the exposure to the counterparty in question and its default risk; • the steps the parties have taken to document progress towards full compliance; • the availability of alternative arrangements to ensure that any non-compliance is contained (such as using existing credit support documentation that may not be compliant with the EU margin rules (e.g. in respect of timing, collateral stated to be eligible for posting, etc.)). In short, the relief is limited in scope and the ESAs expect Competent Authorities to continue to apply their supervisory powers.	White & Case Client Alert Statement from the ESAs
Japan	Japan Financial Services Agency	Variation margin requirements commenced on 1 March 2017. However, the Japan Financial Services Agency has stated that, if the counterparty is located outside Japan where variation margin requirements have not been effective and a Japanese financial institution has difficulty in entering into the necessary	JFSA

		documentation required for the margin regulations, the Japan Financial Services Agency will consider, for the time being, that the appropriate management system required by the margin regulations has been established so long as the relevant Japanese financial institution has established appropriate measures to reduce the counterparty risks in line with the margin regulations and continuously strives to comply with the regulations, including without limitation, addressing of the remaining risks and managing the exposure.	
Hong Kong	Hong Kong Monetary Authority	Authorised Institutions incorporated in Hong Kong and overseas are required to comply with margin requirements when they enter into in-scope uncleared OTC derivatives with a covered entity. Variation margin requirements apply to new transactions entered into on or after 1 March 2017. Initial margin requirements, on the other hand, apply in accordance with a phase-in schedule. Both requirements are now subject to an initial 6-month transition period (1 March 2017 to 31 August 2017).	HKMA – Supervisory Policy Manual
Singapore	Monetary Authority of Singapore (MAS)	MAS Covered Entities entering into in-scope uncleared OTC derivatives booked in Singapore are required to comply with the margin requirements. Variation margin requirements apply to new transactions entered into on or after 1 March 2017. Initial margin requirements, on the other hand, apply in accordance with a phase-in schedule. Both requirements are now subject to an initial 6-month transition period (1 March 2017 to 31 August 2017).	MAS – Singapore Margin Guidelines MAS Response – Policy Consultation on Margin Requirements (December 2016)
Australia	Australian Prudential Regulation Authority (APRA)	If an APRA covered entity enters into a new uncleared OTC derivative transaction, with the exception of a physically settled FX forward or swap, with a covered counterparty during the margining period 1 March 2017 to 31 August 2017, the APRA covered entity will be taken to comply with the variation margining requirements in CPS 226 if it uses its best endeavours to exchange variation margin with the covered counterparty during that period. If the transaction remains open on 1 September 2017, the APRA covered entity must exchange variation margin for the transaction from 1 September 2017.	CPS 226

Brexit Update:

The UK Supreme Court Ruling on Article 50, the Great Repeal Bill and the Commencement of the Departure Process

Introduction

In the January edition of the Delta Report, we discussed the pending Article 50 challenge before the UK Supreme Court (the "**Supreme Court**") and highlighted some of the issues and uncertainties surrounding Brexit, in particular as to whether the UK government could retain its original Brexit timetable1. In this edition of the Delta Report, we look to provide an update on the impact of the Supreme Court ruling, summarise some of the key findings in the judgment and look at the next steps in the form of the UK government's 'Great Repeal Bill'.

Events since 24 January 2017

On 24 January 2017, the Supreme Court delivered one of the most significant constitutional decisions of this generation, dismissing the Secretary of State for Exiting the European Union's appeal against an earlier Divisional Court ruling[2] and ruling by an 8 to 3 majority that Article 50 of the Treaty on European Union[3] ("**Article 50**") cannot be triggered without an authorising Act of Parliament[4].

Following the ruling, on 13 March 2017, the European Union (Notification of Withdrawal) Bill was passed by both Houses of Parliament[5]. The Bill subsequently received Royal Assent and became an Act of Parliament on 16 March, 2017.

With Parliament's consent duly obtained, on 29 March 2017, the Prime Minister sent a letter to the European Council President, Donald Tusk, formally notifying the European Council of the UK's intention to withdraw from the European Union in accordance with Article 50. The letter also included notification of the UK's intention to withdraw from the European Atomic Energy Community[6]. The Prime Minister explained that the government's wish was to agree the terms of the UK's future partnership with the European Union alongside the terms of its withdrawal; a process that the EU's chief negotiator for Brexit, Michel Barnier, and the European Parliament appear inclined to reject[7].

Following the delivery of formal notice under Article 50, on 30 March 2017, the Department for Exiting the European Union ("**DEXEU**") released a White Paper, 'Legislating for the United Kingdom's withdrawal from the European Union' (the "**White Paper**"). The White Paper explains how the UK government will legislate for the conversion of EU law into UK law from the date of exit via a 'Great Repeal Bill', which will be introduced in the next parliamentary session.

On 5 April 2017, the EU Parliament adopted a resolution approving initial negotiating guidelines for the Brexit negotiation. These guidelines looked to ensure that the UK abides by its current budgetary obligations, heeds the jurisdiction of the European Court of Justice (the "**ECJ**") and supports the common EU trade policy, while it is still a member. This final obligation restricts the UK from striking trade deals with countries bilaterally before

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1 Brexit update: the Article 50 Challenge, the Great Repeal Bill and Issues around Timing, available at: https://www.whitecase.com/publications/article/brexit-update-article-50-challenge-great-repeal-bill-and-issues-around-timing#

2 R (Miller) v The Secretary of State for Exiting the European Union [2016] EWHC 2768 (Admin).

3 Treaty on European Union and the Treaty on the Functioning of the European Union ("**TEU**").

4 R (on the application of Miller and another) v Secretary of State for Exiting the European Union 2016 UKSC 5.

5 The House of Lords attempted to pass two amendments to the bill; the first required the Prime Minister to guarantee the rights of EU and EEA citizens legally resident in the UK after Brexit and the second was designed to require parliamentary approval for the outcome of negotiations with the EU. These were ultimately unsuccessful when the bill returned to the House of Commons. See http://www.parliament.uk/business/news/2017/february/lords-debates-european-union-notification-of-withdrawal-bill/

6 Available at, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/604079/Prime_Ministers_letter_to_European_Council_President_Donald_Tusk.pdf?_ga=1.3473779.2140572937.1491483822

7 http://europa.eu/rapid/press-release_SPEECH-17-723_en.htm

it has left the EU[8]. On 29 April 2017, the European Council also published its "*Guidelines for Brexit Negotiations*" which set out some of the core principles that will govern the negotiations and related procedural steps. The guidelines rejected a key demand of the UK government that "divorce negotiations" on the terms of the exit run in parallel with those surrounding the agreement for a future trade relationship. The European Council is committed to dealing with the former before moving onto the latter, thereby greatly increasing the likelihood that some form of transition period will be necessary ahead of the March 2019 deadline.

Potential further uncertainty surrounding the process was also introduced on 18 April 2017 by an announcement from the Prime Minister that the UK government will seek to dissolve Parliament and hold a snap general election on 8 June 2017. Depending on the results of that election, the negotiating position (and indeed the composition of the UK government) could be dramatically altered.

1. The Supreme Court Judgment

The main issue argued before the Supreme Court was whether a formal notice of withdrawal under Article 50 can lawfully be given by ministers without an authorising Act of Parliament.

In order to address this point, the two issues the Supreme Court considered were:

(i) the extent of ministers' power to effect changes in domestic law through exercise of their prerogative powers at the international level; and

(ii) the relationship between the UK government and Parliament on the one hand and the devolved institutions of Scotland, Wales and Northern Ireland on the other.

(i) Ministers' power to effect changes in domestic law through exercise of prerogative powers

The Supreme Court explained that a core provision of the Act of Parliament that ratified the UK's accession to the then European Economic Community, the European Communities Act 1972 (the "**ECA**"), was to put in place a dynamic process by which EU law becomes a source of UK law (and one that takes precedence over all domestic sources of UK law)[9]. Further, withdrawal from EU constitutes a fundamental constitutional change in the UK whereby EU law ceases to be part of the UK's domestic law and the ECJ will no longer be the final court of appeal. The Supreme Court was of the opinion that it would be "*inconsistent with long-standing and fundamental principle for such a far-reaching change to the UK constitutional arrangements to be brought about by ministerial decision or ministerial action alone*"[10]. Applying these basic concepts of constitutional law, the Supreme Court held that withdrawal "*must be effected in the only way that the UK constitution recognises, namely by Parliamentary legislation*"[11].

Arguments raised before the Supreme Court

The arguments advanced by Counsel for the government were based on the existence of the long-established 'prerogative powers' of the Crown to enter into and to withdraw from international treaties. Counsel argued that the government was entitled to exercise this prerogative power in relation to the EU Treaties and could therefore serve the Article 50 notice without first obtaining authorisation from Parliament. In the government's view, the ECA did not exclude the ministers' prerogative powers to withdraw from the EU Treaties and did not prevent the government from serving the Article 50 notice. Counsel further submitted that after giving the Article 50 notice, the Great Repeal Bill will be laid before Parliament to repeal the ECA (and convert EU law into domestic law in its legislative capacity).

Counsel for the applicants argued that giving the notice effectively initiates an irreversible course that will lead to several EU laws ceasing to have any effect in the UK, irrespective of whether or not Parliament repeals the ECA. The ECA would therefore become devoid of meaning at that point. The giving of the notice would therefore pre-empt the decision of Parliament on the Great Repeal Bill. The applicants argued that this executive action is equivalent to altering an Act of Parliament without Parliament's approval and thus was not in accordance with UK's constitution.

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[8] Remarks by President Donald Tusk on the next steps following the UK notification, available at http://www.consilium.europa.eu/en/press/press-releases/2017/03/31-tusk-remarks-meeting-muscat-malta/

[9] R (Miller) v The Secretary of State for Exiting the European Union [2016] EWHC 2768 (Admin), Para 60.

[10] Ibid, Para 81.

[11] Ibid, Para 82.

The Supreme Court rejected the government's arguments and held that it is a fundamental principle of the UK constitution that, unless primary legislation permits it, the prerogative powers do not enable ministers to change statute law or common law[12]. The Supreme Court explained that there is a "*vital difference between variations in the UK law resulting from changes in EU law, and variations in UK law resulting from withdrawal from EU Treaties*"[13]. The majority held that withdrawing from the European Union (by serving the Article 50 notice) constitutes a significant constitutional change and that "*the continued existence of the new source of law created by the 1972 Act and the continued existence of the rights and other legal incidentals which flow therefrom, cannot as a matter of UK law have depended on the fact that to date ministers have refrained from having recourse to the Royal prerogative to eliminate that source*". The Supreme Court also noted that an inevitable consequence of withdrawing from the EU is the need to legislate on a vast number of points currently dealt with under EU law and such a burden should not simply be imposed on Parliament by the minister's exercise of prerogative powers and without its authorisation. In short, Parliament is sovereign and only it may remove the rights and source of law bestowed upon citizens of the UK by the ECA.

(ii) The Devolution Issues in relation to the devolved institutions of Scotland, Wales and Northern Ireland on the other

The devolution issues raised before the Supreme Court were not considered in the Divisional Court; they were brought before the Supreme Court by way of references from the High Court of Justice in Northern Ireland (NI), the Court of Appeal in NI[14] and interventions by the Lord Advocate for the Scottish Government and the Counsel General for Wales for the Welsh government. The devolution issue under consideration by the Supreme Court was whether the terms on which powers are statutorily devolved to the administrations of Scotland, Wales and Northern Ireland meant that the consultation or agreement with the devolved legislatures was required before the Article 50 notice could be served.[15]

When dealing with the issue on legislative competence of the devolved legislations, the Supreme Court noted that relations with the EU within the UK are reserved or excepted in the cases of Scotland and Northern Ireland and are not devolved in the case of Wales.[16] Further, although Parliament proceeded with the assumption that UK would be a member of the EU when enacting EU constraints in these devolution Acts, "*in imposing the EU constraints and empowering the devolution legislation to observe and implement EU law, the devolution legislation did not go further and require the UK to remain a member of the EU*". Accordingly, the Supreme Court stated that section 1 of the NIA did not regulate any changes in the constitutional status of Northern Ireland other than giving the people in Northern Ireland the right to determine whether or not to remain in the UK. Further, the Supreme Court pointed out that section 75 of NIA which imposes certain obligations on a 'public authority' when carrying out its functions in relation to NI, does not apply to the Secretary of the State as the definition of 'public authority' does not include a minister of the Crown[17]. The Supreme Court further noted that the decision to withdraw from the EU is thus not a function carried out by the Secretary of State for NI in relation to NI within the meaning of section 75. Due to these reasons, the Supreme Court held that the devolved legislatures do not have a "*parallel legislative competence in relation to withdrawal from the EU*".

The Supreme Court also noted that constitutional conventions such as the 'Sewel Convention'[18] play a fundamental role in the operation of UK's constitution and act as a "*political restriction*" on the actions of UK Parliament[19]. However, it pointed out that the courts cannot enforce these political conventions[20] and past

[12] Ibid, Para 50. Known as the "De Keyser principle" - Attorney General v De Keyser's Royal Hotel Ltd [1920] AC 508.

[13] Ibid, Para 83.

[14] Ibid, Para 126.

[15] Ibid, Para 6.

[16] See section 30(1) and paragraph 7(1) schedule 5 of the Scotland Act 1998, section 4(1) and paragraph 3 of schedule 2 of the Northern Ireland Act (NIA) and section 4(1) and paragraph 3 of schedule 2 of the Northern Ireland Act (NIA).

[17] Section 75(1) of the NI Act obliges a public authority in carrying out its functions in relation to Northern Ireland to "have due regard to the need to promote equality of opportunity" By section 75(2), this duty includes an obligation to have regard to the desirability of promoting good relations between persons of different religious belief, political persuasion or radical group. Section 75(3) defines "public authority"

[18] The Sewel convention was adopted as a means of establishing cooperative relationships between the UK Parliament and the developed institutions (i.e., Scotland, Wales and Northern Ireland), where there were overlapping legislative competences.

[19] The UK government and devolved executives agreed the mechanisms for implementing the convention in their Memorandum of Understanding. Para 14 of Memorandum of Understanding states as follows: "The UK Government

attempts to enforce such conventions have failed[21]. The Supreme Court further held that Article 9 of the Bill of Rights, which provides that "proceedings in Parliament ought not to be impeached or questioned in any court or place out of Parliament", provides a further reason why the courts cannot adjudicate on the operation of this convention.[22] For these reasons, the Supreme Court held that the Sewel Convention does not give rise to a legally enforceable obligation and falls outside the constitutional remit of the courts.

The Supreme Court concluded by stating that although the Devolution Acts were passed by Parliament on the assumption that the UK would be a member of the EU, they do not require the UK to remain a member[23]. The devolved legislatures thus do not have a right of veto over the UK's decision to withdraw from the EU[24].

2. The Great Repeal Bill

In the White Paper, the government stated its intention to provide certainty for businesses and individuals and allow for a fair and open trading environment following Brexit. An important part of the government's plan to deliver a smooth and orderly Brexit is the introduction of the 'Great Repeal Bill'.

The aim of the Bill is to end the supremacy of EU law in Britain, maximise certainty for business, workers, investors and consumers across the UK after Brexit and ensure accountability for the powers contained in the Bill. The government in the White Paper, noted that the influence of European legislation will continue; for instance, the past rulings of the ECJ will continue to bind the UK by giving them the same status as rulings by the Supreme Court. However, the government's intention post Brexit is for new ECJ rulings[25] to no longer form part of UK law. Existing legal rights and obligations in the UK shall continue to be the same where possible following Brexit, unless domestic law is changed by way of separate legislation.

In order to achieve the above aims of the government, the Bill will do three main things:

(1) repeal the ECA and return powers to UK institutions;

(2) convert EU law (as it stands at the moment of exit) into UK law before leaving the EU; and

(3) create powers to make secondary legislation to enable corrections to be made to the laws that would otherwise no longer be appropriate once the UK leaves the EU and enable domestic law to reflect the content of any withdrawal agreement under Article 50, (so called "**Henry VIII powers**")[26].

The White Paper acknowledges that there will be gaps where some areas of converted law will be unable to operate in their entirety because the UK will no longer be an EU member. This is a particular issue where EU law is based on reciprocal arrangements with all EU member states treating certain situations in the same way. If the UK fails to secure such reciprocal arrangements as part of the new relationship with the EU, such laws will become unworkable in the UK.[27]

The Great Repeal Bill will also provide a power to correct the statute book, where necessary to rectify problems occurring as a consequence of leaving the EU. This will be done using the secondary legislation via Henry VIII powers. Primary legislation can provide a framework within which Government can propose secondary legislation or parliamentary approval. This power is granted by and subject to Parliament's control.

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will proceed in accordance with the convention that the UK Parliament would not normally legislate with regard to devolved matters except with the agreement of the devolved legislature. The devolved administrations will be responsible for seeking such agreement as may be required for this purpose on an approach from the UK Government" Section 5 of the NI Act empowers the Northern Ireland Assembly to make laws, but subsection (6) states that "[t]his section does not affect the power of Parliament of the United Kingdom to make laws for Northern Ireland". Section 28(7) of the Scotland Act 1998 provides that the section empowering the Scottish Parliament to make laws: "does not affect the power of Parliament of the United Kingdom to make laws for Scotland". Substantially identical provision is made for Wales in section 107(5) of the Government of Wales Act 2006.

[20] R (Miller) v The Secretary of State for Exiting the European Union [2016] EWHC 2768 (Admin), Para 141.

[21] Ibid, Para 144.

[22] Ibid, Para 145.

[23] Ibid, Para 129-130.

[24] Ibid, para 136 - 151.

[25] The negotiation guidelines proposed by EU suggest the need for a transitional agreement following the formal date set for exit (2 years from serving the notice) during which UK would remain subject to the jurisdiction of ECJ.

[26] White Paper, 'Legislating for the United Kingdom's withdrawal from the European Union'

[27] Ibid.

The secondary legislation will be used only for the purpose of correcting the deficiencies in preserved EU-derived law. For instance, EU financial services regulation would be converted into UK law via the 'Great Repeal Bill'. References in that legislation to EU bodies and (for example) any references to peculiarities of other EU Member States would be amended via secondary legislation. Any amendments to the EU regulations and implementation of new policies in areas that formerly lay within the EU's competence will be carried out through primary legislation.[28]

Parliament will also be empowered to review all statutory instruments created under these delegated powers with different levels of scrutiny. Time limits will also be placed on these delegated powers since they do not need to exist in perpetuity. The Government intends to have most of the corrections made before the UK leaves the EU in order that the powers do not have to subsist for long following the UK's departure.[29]

Two Months After The Margining Big Bang – The State Of Play

Introduction

As we reported in our December 2016 issue of the Delta Report, the derivatives market has been working steadily towards a Q1 2017 phase-in commencement in respect of the rules for margining of non-cleared derivatives (the "**Margin Rules**"). The regulatory technical standards submitted by the European Commission (following review, discussion and amendment of the version submitted to them by the European Supervisory Authorities ("**ESAs**")) were published in the Official Journal of the European Union in December 2016[30] and entered into force on 4 January 2017. From 4 February 2017, counterparties who each had a group aggregate average notional amount of EUR 3 trillion for non-cleared derivatives[31] were required to begin posting both initial margin ("**IM**") and variation margin ("**VM**") (with a phase-in then commencing on such date through to 1 September 2020). On 1 March 2017, it was intended for there to be a market "big bang" bringing all FC's and NFC+'s[32] within scope of the obligation to post VM in accordance with the Margin Rules. However, this represented a herculean task for the derivatives market and, across dealers, the average combined execution rate of CSAs which were ready to trade was estimated at less than 3 per cent. shortly prior to the deadline[33]. Clearly some form of delay or relief was necessary, although regulators around the world have responded to such requests with varying degrees of sympathy[34]. This article looks to provide detail on the nature of that relief in the European Union ("**EU**") as well as outlining the key current issues for market participants arising from the Margin Rules and the related documentation and processes finally being put to the test.

Update

Despite the market working flat-out to achieve compliance in line with the implementation timeline (as described above), the sheer volume of re-papering and (in many cases) new documentation required by the Margin Rules meant that many users have been unable to meet the strict deadlines imposed. It was reported by the Investment Adviser Association at the end of January 2017 that, for non-dealers, 92% of participating firms reported completion of 10 or fewer regulatory-compliant credit support documents[35]. In particular (and as further outlined below), the lack clarity around settlement timing, issues around the application of the "*Minimum Transfer Amount*" ("**MTA**"), the need to draft documents for compliance with multiple margining regimes, assessing how to apply the requirements for counterparties in non-netting jurisdictions and disharmonised global effective dates have all led to significant delays in finalising the necessary documentation. This was particularly acute in the EU given the Margin Rules only took final form in October 2016. Likewise, many users with existing documentation have been reluctant to agree a new document that

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28 Ibid.

29 Ibid.

30 http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&from=EN

31 Calculated on the basis of (a) the average of total gross notional amount recorded as of the last business day of each testing month then an average of the 3 numbers is taken (b) including all entities that consolidate accounts (c) including all non-centrally cleared OTC derivative contracts of that group (including intra-group but counted only once) and (d) assessed on an annual basis in March, April and May with requirements applied the same year.

32 As defined in the Regulation No 648/2012 of the European Parliament and of the Council ("**EMIR**").

33 Letter from, among others, the International Swaps and Derivatives Association Inc. ("**ISDA**") and the European Banking Authority to G20 regulators around the world dated 7 February 2017.

34 See further the summary table in this issue of the Delta Report which outlines the various reliefs granted by regulators globally.

35 See SIFMA and IAA letter from 24 January 2017: http://www.sifma.org/issues/item.aspx?id=859964521

removes protections and bespoke terms in such existing documentation that are still permitted under the Margin Rules. This has significantly reduced the ability of larger institutions to roll out a template form that can be quickly agreed with counterparties.

As such, the race for compliance is now focused on ensuring that all necessary documentation is in place as soon as possible and that every effort has been made to advance the process with counterparties trading after 1 March 2017 without compliant documentation in place.

Implementation Timeline – Europe

As mentioned above, from 1 March 2017 it was planned for there to be a market "big bang" in the EU bringing all FCs and NFC+s within scope of the obligation to post variation margin in accordance with the Margin Rules (the "**1 March VM Requirements**").

Following the actions of the US regulators[36], the ESAs opted to issue a similar (although more limited) statement granting a degree of flexibility for certain parties who were required to comply with the 1 March VM Requirements.

On 23 February 2017, the ESAs issued a statement explaining that, unlike in other jurisdictions (such as the US), the ESAs lack the power to issue no-action letters or formally disapply (on a temporary or permanent basis) any directly applicable EU legislative text. However, it was noted that the implementation of the 1 March VM Requirements was an issue for the industry and appeared to "*mainly pose a challenge for smaller counterparties*" (i.e. smaller FCs on the buy-side of the market and NFC+s). Taking this into account, it noted that, although the ESAs still expect Competent Authorities (being the relevant regulator in each EU member state) to generally apply their risk-based supervisory powers to enforce applicable legislation, in this context they may take into account:

- the size of the exposure to the counterparty in question and its default risk;
- the steps the parties have taken to document progress towards full compliance; and
- the availability of alternative arrangements to ensure that any non-compliance is contained (such as using existing credit support documentation that may not be compliant with the Margin Rules (e.g. in respect of timing, collateral stated to be eligible for posting etc)).

The ESAs noted that the statement was not intended to entail general forbearance from the 1 March VM Requirements. Rather, Competent Authorities should, on a case-by-case basis, assess the degree of compliance and progress by parties subject to the 1 March VM Requirements.

The ESAs did not state a hard deadline by which this flexibility around enforcement will end, it is noted that they expect "the difficulties to be solved in the coming few months and [in any case] that transactions concluded after 1 March 2017 remain subject to the obligation to exchange variation margin".

UK Financial Conduct Authority

Following the ESAs statement, the UK Financial Conduct Authority ("**FCA**"), being the Competent Authority in the UK, issued a press release, welcoming the statement from the ESAs and confirming that it will look to take a "*risk- based approach and use judgement as to the adequacy of progress, taking into account the position of particular firms and the credibility of the plans they have made*". It is noted that, where full compliance has not been achieved, the FCA expects a demonstration of how:

- the relevant parties subject to the 1 March VM Requirements have made "best efforts" to achieve full compliance; and
- the parties will achieve compliance in a short a time as practicable for all transactions that are in-scope for the purposes of the Margin Rules. The FCA also noted that it will expect full compliance within "*a few months*".

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[36] See footnote 5.

Impact for Market Participants

While less formal than the relief granted by other regulators globally, the statement by the ESAs is nevertheless helpful in mitigating concerns for larger FCs/ dealer banks operating in Europe (and, in respect of the FCA statement, in London in particular) around trading with counterparties where they do not yet have documentation in place that is compliant with the Margin Rules. Given the ESA statement and the FCA press release note that assessment of compliance (and any subsequent enforcement action) will be carried out on a case-by-case basis, parties should work to ensure that they have in place a detailed internal roadmap to full compliance in place, clear, documented steps showing progress for each counterparty and evidence that any existing credit support arrangements are being utilised. This should assist Competent Authorities with exercising their discretion appropriately where smaller FCs and NFC+s are concerned.

Key Current Issues

Minimum Transfer Amount

In the context of VM, the MTA represents the maximum unsecured credit exposure that parties are now permitted to have at any given time as the Margin Rules no longer permit the inclusion of a "Threshold" and require collateral equal the full mark-to-market exposure within a netting set[37] to be posted.

In the context of both IM and VM[38], this provision[39] looks to avoid minor amounts of collateral moving back and forth between the parties as a result of small movements in the mark to market of the outstanding transactions (or the model in the case of IM) within a netting set, thereby creating an unnecessary administrative burden. The Margin Rules provide that the MTA may not exceed EUR 500,000 for each netting set[40]. It may be divided between the two counterparties to the netting set and may also be applied to the combined amount of IM and VM to be posted; however, it cannot exceed EUR 500,000 in total[41]. Once the Minimum Transfer Amount is reached, the full amount must be posted.

The provision has caused an operational headache for a number of market participants and, in particular, for funds where the fund manager trades using one netting set for the benefit of a number of sub-funds. The Margin Rules do not make any express provision governing how the Minimum Transfer Amount should be calculated in those circumstances. It is arguable that the strict wording of the rules therefore requires Minimum Transfer Amounts to be calculated on the basis of the legal entity, rather than at individual account level – an approach that would present operational difficulties for fund managers and their counterparties. Dealers have been working with their clients to put in place bespoke arrangements to avoid ending up with an MTA for simplicity of zero but this has put further strain on agreeing the documentation within the timeframes originally set by regulators and the position for the purposes of the Margin Rules remains unclear[42].

Non-netting jurisdictions

The Margin Rules make specific provision for OTC derivatives with counterparties in third countries where the legal enforceability of close-out netting or collateral protection cannot be ensured ("**non-netting**

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37 Defined in Article 1(3) as a "*set of non-centrally cleared over-the-counter (OTC) derivative contracts between two counterparties that is subject to a legally enforceable bilateral netting agreement*".

38 Although the MTA is applicable in the context of IM, the Margin Rules also permit counterparties required to post IM to have a threshold amount of EUR 50 million where the counterparties are part of different groups (or do not belong to any group) and EUR 10 million where the counterparties belong to the same group. These are maximum levels below which counterparties can choose not to collect IM.

39 See for example Paragraph 2 of the English law governed 2016 Credit Support Annex for Variation Margin (VM) (the "**VM CSA**") and Paragraph 3 of the English law governed 2016 Phase One IM Credit Support Deed (the "**IM CSD**"). Corresponding provisions can also be found in the New York law governed credit support documentation published by ISDA.

40 Article 25(1) of the Margin Rules.

41 Article 25(4) of the Margin Rules.

42 The Commodities Futures Trading Commission in the United States has noted the urgency of addressing this point and issued a "No-action Letter" that grants exemptive relief related to the application of the minimum transfer amount to separately managed accounts. See: http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/17-12.pdf

jurisdictions"). The Margin Rules[43] set out two possible approaches and related obligations for EU counterparties facing entities established in non-netting jurisdictions. These are as follows:

- Article 31(1) of the Margin Rules, which provides that if the legal review[44] is unable to confirm that the netting agreement and, where used, the exchange of collateral is legally enforceable *at all times* or (if applicable) the legal review[45][46] is unable to confirm that the collateral segregation requirements can be met, then EU counterparties are required to ***collect collateral on a gross basis and are not required to post collateral***; and

- Article 31(2) of the Margin Rules, which provides that if the legal review confirms that collecting collateral even on a gross basis is not enforceable *at all times*, then EU counterparties are permitted ***to not post or collect collateral***, provided that transactions with such entities do not exceed 2.5% of the total portfolio of OTC derivatives contracts of the relevant EU counterparty and its group.

The original wording of this provision was subject to significant lobbying by industry groups during the consultation period for the Margin Rules with market participants arguing for a blanket carve-out for the exchange of collateral with counterparties based in non-netting jurisdictions. Article 31 represents the compromise position agreed by the ESAs. However, this has presented further issues with establishing the circumstances in which it can be said that "*collection… even on a gross basis is not enforceable*". Clearly a country-by-country assessment to establish whether this is necessary, which will involve additional cost and time in jurisdictions where industry standard opinions on the enforceability of collateral arrangements (and/or segregation arrangements) have not yet been published. Once advice is obtained, EU counterparties should, at a minimum, be looking to establish the following:

(1) Is close-out netting a recognised legal concept in the relevant non-netting jurisdiction and will it be enforceable (as the Margin Rules require) under the laws of that jurisdiction?

(2) Is the exchange of collateral (either on a security interest or title transfer basis, as applicable) with counterparties based in the relevant non-netting jurisdiction considered to be enforceable under the laws of that jurisdiction?

(3) Where the parties would be required to exchange IM, are there any laws that require or provide for the ability to segregate margin that has been posted?

(4) On the basis of the answers to questions (1) to (3), is there legal certainty that close-out netting, the exchange of collateral and (where applicable) segregation arrangements will, at all times, be enforceable?

If the answer to question (4) is in the negative, then parties should be in a position to avail themselves of the exemption in Article 31(2), up to the mandatory limit for the portfolio of 2.5 per cent.[47] In this regard, it is important to note that Recital 18 of the Margin Rules in respect of third countries recognises the need "*to avoid that it becomes impossible for Union counterparties to trade with counterparties in those jurisdictions*". This would also seriously impact the ability of EU counterparties to trade with such jurisdictions in contrast to other jurisdictions where the rules are less prescriptive.

To assist counterparties who wish to rely on Article 31(1), the relevant ISDA working group has published two supplements to the ISDA 2016 Variation Margin Protocol (the "**VM Protocol**"), which set out amendments to the "New CSA" that is generated by the VM Protocol to allow for either "gross/gross" or "gross/net" margining[48] (the "**Non-Netting Supplement**"). However, it has been reported that certain buy-side counterparties in non-

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43 Article 31(1) of the Margin Rules.

44 As required by Article 2(3) of the Margin Rules.

45 Article 19(6) of the Margin Rules.

46 This is known as a "negative netting opinion". The difficulty is that trying to prove a negative is much harder than proving a positive with acceptable qualifications. No guidance has been provided by the European Securities and Markets Authority or the FSA as to what such an opinion would need to state in order for a jurisdiction to be regarded as a "non-netting" jurisdiction.

47 It is clear that any trading in excess of that threshold will not be permitted under the Margin Rules.

48 http://www2.isda.org/functional-areas/wgmr-implementation/isda-2016-variation-margin-protocol/ Parties should note that these changes can also be made to the standard form credit support documentation that is agreed bilaterally (e.g. via Paragraph 11 of the VM CSA).

netting jurisdictions are stating that they would not be willing to sign-up to an agreement to post gross and receive no collateral back[49]. One may therefore query whether counterparties will instead try to push as much trading into the Article 31(2) bucket (which is subject to the 2.5 per cent. cap) as is possible within the scope of the legal reviews that can be obtained. In summary, trading with counterparties in non-netting jurisdictions is likely to require considerable analysis where they trade with an EU based counterparty subject to the Margin Rules.

As may be apparent, this has also created further issues with how to apply the MTA to credit support annexes which adopt this wording. The working group has also published an amendment agreement[50] (the "**MTA Amendment Agreement**") to address this scenario. Under the approach envisaged by the Non-Netting Supplement, the MTA is split by the parties and allocates 50 per cent. of the originally selected MTA to each delivery/return amount as a "gross MTA" or "net MTA". The MTA Amendment Agreement allows the parties to replace that approach by defining a "gross MTA" or "net MTA" to equal the full amount of the originally selected MTA (or insert a different amount).

Transfer Timing – Variation Margin

The Margin Rules provide in Article 12 that VM must be posted on the same business day (with allowance for time-zone differences) or within two business days for where either (a) IM is posted and an additional amount has been provided to cover the two business day gap or (b) no IM is due but an additional amount has been posted to cover the two business day gap (i.e. non-regulated IM).

As was argued throughout the consultation process, this appeared unworkable, particularly for buy-side market participants who often have chains of custodians and sub-custodians to instruct in order to transfer margin. It was clarified during the final debates on the Margin Rules in the European Parliament that the obligation is to *post* (i.e. to give an instruction to transfer funds/ collateral) on the same day of demand; however, this doesn't require same day settlement to occur. The market position settled upon has therefore been reflected in a revised supplement to the VM Protocol[51] which provides that transfer requests received before the "Notification Time" [52] will be initiated on the same business day and those received after the "Notification Time" specified on the next business day. Cash margin is then expected to settle, at the latest, on the next business day and securities in accordance with the customary procedure for settling through clearing systems.

Applicability of US Margin Rules to EU Based Subsidiaries

Another issue that has generated significant concern, particularly in the structured finance space, is around the extra-territorial application of the margining regime (as issued by multiple regulators in the US) to subsidiaries of US banking institutions based in Europe. Our client note on this topic outlines the issues and the related relief granted by the Commodity Futures Trading Commission in respect of their margin rules[53]. However, as many such subsidiaries are regulated by Prudential Regulators[54] in the US (who have not released corresponding relief pertaining to their (separate) margin rules[55]), it is clear that issues still remain in this regard.

https://www.whitecase.com/publications/alert/cftc-issues-no-action-relief-swap-dealers-complying-eu-margin-rules

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[49] http://www.risk.net/derivatives/4799726/dealers-struggle-with-vm-in-non-netting-jurisdictions Instead, such counterparties would be pushing to exchange collateral on a "gross/gross" basis. This is likely to create pricing implications for users.

[50] *See above footnote.*

[51] *See footnote 18.*

[52] As defined and as specified in the relevant credit support document.

[53] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 FR 635 (January 6, 2016), available at https://federalregister.gov/a/2015-32320

[54] The five Prudential Regulators are the Federal Deposit Insurance Corporation, the Department of the Treasury (the Office of the Comptroller of the Currency), the Board of Governors of the Federal Reserve System, the Farm Credit Administration and the Federal Housing Finance Agency.

[55] Margin and Capital Requirements for Covered Swap Entities, 80 FR 74839 (November 30, 2015), available at https://federalregister.gov/a/2015-28671

Conclusion

It remains clear two months after the 1 March VM Requirements commencement date that there remains a significant amount of work to do to ensure no party finds itself on a no-trade list. We are still receiving instructions from clients (particularly end-users) who were not aware of their obligations under the Margin Rules having not previously been required to exchange collateral. As this documentation is put into place, particular issues – including but by no means limited to those outlined above – arise which require bespoke amendments for counterparties depending on their jurisdiction of incorporation, credit profile and operational capabilities. In short, plenty of challenges remain in complying with the 1 March VM Requirements and, as time passes, it will become harder to justify relying upon the soft relief granted by regulators, particularly in the EU.

Article 55 and the ISDA 2016 Bail-in Article 55 BRRD Protocol

Introduction

ISDA published on 14 July 2016 the "ISDA 2016 Article 55 BRRD Protocol (Dutch/French/German/Irish/Italian/Luxembourg/Spanish/UK entity-in-resolution)" (the "**Bail-in Protocol**"). The Bail-in Protocol aims to facilitate market participants compliance with Article 55 of the Bank Recovery and Resolution Directive ("**BRRD**"). This article discusses the background and the key legal and practical aspects of the Bail-Protocol.

What is the background to the Bail-in Protocol?

From 1 January 2016, BRRD Entities[56] (excluding (e) as per the definition) are required under Article 55 to include certain contractual terms in any agreements governed by the laws of non-EU Member States to recognise the bail-in tool under the BRRD, subject to certain exclusions. This contractual recognition requirement is designed to ensure the effectiveness of the bail-in tool in a cross-border resolution and to promote equal treatment between EU and third-country creditors.

The contractual recognition consists of a contractual term by which the creditor or party to an agreement creating the liability: (a) recognises that such liability may be subject to bail-in (write-down and conversion powers); and (b) agrees to be bound by any reduction of the principal or outstanding amount due, conversion or cancellation that is effected by the exercise of those powers by a resolution authority (a "**RA**").

Under Article 55 the obligation to include the contractual recognition of bail-in applies to any liabilities that meet all of the following criteria:

(i) not excluded under Article 44(2) of the BRRD;

(ii) not a deposit referred to in point (a) of Article 108 of the BRRD;

(iii) governed by the law of a third country; and

(iv) issued or entered into after the date on which a Member State transposes into national law the provisions of the BRRD (1 January 2016 at the latest or earlier).

[56] BRRD Entity means:

(a) credit institutions and investment firms that are established in the EU;

(b) financial institutions that are established in the EU when the institution is a subsidiary of a credit institution or investment firm (or of a company referred to in (c) and (d) below) and is covered by the supervision of the parent undertaking on a consolidated basis;

(c) financial holding companies, mixed financial holding companies and mixed-activity holding companies that are established in the EU;

(d) parent financial holding companies in a Member State, EU parent financial holding companies, parent mixed financial holding companies in a Member State, EU parent mixed financial holding companies; and

(e) EU branches of institutions that are established outside the EU in accordance with specific conditions laid out in the BRRD.

Non-EU incorporated firms and their EU branches are out of scope for the purposes of Article 55. Amongst the list of "*excluded liabilities*" listed in Article 44(2) of the BRRD, the most relevant to derivative markets is "*secured liabilities*", provided they meet the relevant requirements.[57]

The contractual recognition requirement will not apply where the RA determines that the law of a third country or a binding agreement concluded with that third country allows the RA to exercise its write down or conversion powers. For example, if a third country (e.g. Brazil) implemented a law or entered into an agreement with the RA, which recognized and gave effect to the exercise of write-down and conversion powers by such RA, Brazilian entities would not be affected by this contractual recognition.

Article 43(2) of the Contractual Recognition RTS[58] clarifies that in point (iv) above, the reference to "liabilities issued or entered into after the relevant transposition date" includes:

(i) liabilities created after that date, regardless of whether they are created under relevant agreements entered into before that date, including under master or framework agreements between the contracting parties governing multiple liabilities;

(ii) liabilities created before or after that date under relevant agreements entered into before that date and which are subject to a material amendment;

(iii) liabilities under debt instruments issued after that date; and

(iv) liabilities under debt instruments issued before or after that date under relevant agreements entered into before that date and which are subject to a material amendment.

Article 55 applies therefore to a very broad range of payment and other contractual and non-contractual liabilities. It includes any loan agreements, guarantees, certain derivatives (which are not excluded liabilities), repos and stock lending arrangements, letters of credit and other similar facilities entered into by BRRD Entities and governed by a third country law, and may extend to intercreditor and security agreements where a liability in respect of a BRRD Entity may arise.

RAs may require BRRD Entities to provide them with a legal opinion relating to the legal enforceability and effectiveness of the contractual recognition.

What is the scope of the Bail-in Protocol and which agreements does it cover?

As set out in further detail below, the Bail-in Protocol covers any agreements which are entered into by the two parties that have adhered to the Bail-in Protocol[59] (the "**Adhering Parties**") and which are documented by either an ISDA Master Agreement[60] ("**Covered ISDA Master Agreements**") or by any other form of master

57 Article 44(2)(b) of the BRRD excludes "secured liabilities including covered bonds and liabilities in the form of financial instruments used for purposes which form an integral part of the cover pool and which according to national law are secured in a way similar to covered bonds". Pursuant to Article 43(1) of the Contractual Recognition RTS for the purposes of Article 55, a secured liability will not be considered as an excluded liability where, at the time at which it is created, it is:

(a) not fully secured;

(b) fully secured but governed by contractual terms that do not oblige the debtor to maintain the liability fully collateralised on a continuous basis in compliance with regulatory requirements of EU law or of a third country law achieving effects that can be deemed equivalent to EU law.

58 The Commission Delegated Regulation (EU) 2016/1075 of 23 March 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council. Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1075&from=EN

59 ISDA members and non-members can adhere to the Bail-in Protocol by submitting an online Adherence Letter through the ISDA Protocol Management section available at its website. Each Adherence Letter will be published by ISDA on its website. Parties will pay a one-time fee of USD 500 to ISDA to adhere to the Bail-in Protocol. There is no cut-off date to the Bail-in Protocol. Please see relevant link for submission: https://www2.isda.org/functional-areas/protocol-management/submit-adherence-letter/28

60 It includes a 2002 ISDA Master Agreement, 1992 ISDA Master Agreement (Multicurrency – Cross Border), 1992 ISDA Master Agreement (Local Currency – Single Jurisdiction), or 1987 ISDA Interest Rate and Currency Exchange Agreement, in each case, (i) as published by ISDA, (ii) governed by the law of a non-EU member state (or, if the implementation of Article 55 of the BRRD in the jurisdiction of the Relevant BRRD Party extends to liabilities governed by non-EEA law, governed by non-EEA law), and (iii) including, without limitation, where such agreement has been amended (whether by addendum or otherwise) to provide for client clearing.

agreement trade terms which is not an ISDA Master Agreement ("**Covered Other Agreements**", and together with the Covered ISDA Master Agreements, the "**Protocol Covered Agreements**"). The Bail-in Protocol applies to a wide range of agreements, the main difference being whether they are documented by an ISDA Master Agreement or a different agreement.

By adhering to the Bail-in Protocol all Protocol Covered Agreements between CBA and any other Adhering Party that are entered into on or prior to the Implementation Date will be captured.

Covered ISDA Master Agreements	Covered Other Agreements
• An ISDA Master Agreement that arises pursuant to a long form confirmation[61] between two Adhering Parties (other than a client) • An ISDA Master Agreement executed between two Adhering Parties (other than a client) • Any umbrella ISDA Master Agreement that is executed directly or arises by execution of a long form confirmation, which in each case is signed by an agent and an Adhering Party, where in respect of the agent, the relevant client on whose behalf the agent acts is a Protocol BRRD Entity[62] and/or the other Adhering Party is a Protocol BRRD Entity (an "**Agent Covered ISDA Master Agreement**").	• Any other Agreement[63] that arises pursuant to a long form confirmation between two Adhering Parties (other than a client) • Any other Agreement executed between two Adhering Parties (other than a client) • Any other Agreement that is executed directly or arises by execution of a long form confirmation, which in each case is signed by an agent and an Adhering Party, where in respect of the agent the relevant client on whose behalf the agent acts is a Protocol BRRD Entity and/or the other Adhering Party is a Protocol BRRD Entity (an "**Agent Covered Other Agreement**").
in each case: • entered into by such Adhering Parties on or prior to the Implementation Date[64] • governed by the law of a non-EU member state or a non-EEA[65] member • at least one of the two Adhering Parties is a Relevant BRRD Entity • the parties have neither addressed these issues by way of alternative written arrangements nor have excluded any matters included in the Bail-in Protocol[66]	

61 A long form confirmation is a document that specifies the terms of a derivative transaction that functions as both an ISDA Schedule and a transaction confirmation. Parties to a derivatives transaction may use a long-form confirmation if they wish to enter into a transaction but have not executed an ISDA Master Agreement (or ISDA Schedule) therefore have no umbrella agreement in place that governs their trading relationship. The long-form confirmation typically states that it supplements, forms a part of and is subject to the terms of, a standard form ISDA Master Agreement without any ISDA Schedule thereto except for limited terms as specified therein.

62 Any entity that may become subject to the exercise of any bail-in power by the resolution authority of The Netherlands, France, Germany, Ireland, Italy, Luxembourg, Spain or the United Kingdom.

63 This may include: any master agreement, framework agreement or master netting or set-off agreement, or any agreement that incorporates master trading terms by reference where such terms may cause all transactions relating to one or more netting sets, as applicable, to terminate (in each case, other than an ISDA Master Agreement), that sets out and/or governs (or has one or more underlying agreements which set out and/or govern) the terms and conditions of such transaction(s), including, without limitation, where such agreement has been amended (whether by addendum or otherwise) or is designed to provide for client clearing (and which includes, for the avoidance of doubt, any compensation agreement or execution agreement relating to give-up arrangements or the trading of cleared derivatives).

64 Or in the case of an Agent Covered ISDA Master Agreement or Agent Covered Other Agreement, executed by the agent and the counterparty prior to adherence by both the counterparty and the agent on behalf of the relevant client (and including all outstanding transactions thereunder and outstanding credit support documents, if any and if applicable, entered into by such Adhering Parties in connection therewith),

65 The European Economic Area ("**EEA**") unites the EU Member States and the three EEA EFTA States (Iceland, Liechtenstein and Norway) into an internal market governed by the same basic rules.

66 If the parties to a Protocol Covered Agreement have:

Where agreements are secured, guaranteed or otherwise supported by a third party and consent, approval, agreement, authorization or other action by a third party is required for amendments to be made to such agreements, such agreements will not be Protocol Covered Agreements unless such consent, approval, agreement, authorization or other action has been obtained.

In particular, if:

(1) any consent, approval, agreement, authorization or other action of any third party is expressly required, under the terms of such third party credit support document or such agreement, to amend or otherwise modify such agreement;

(2) such third party credit support document or such agreement includes express terms to the effect that any amendment or modification of such agreement without the consent, approval, agreement, authorization or other action of any such third party would void, impair or otherwise adversely affect existing or future obligations owed under such third party credit support document; or

(3) such agreement, if amended or modified in accordance with the Bail-in Protocol without the consent, approval, agreement, authorization or other action of any such third party would void, impair or otherwise adversely affect existing or future obligations owed under such third party credit support document,

then such agreement shall not be a Protocol Covered Agreement unless such consent, approval, agreement, authorization or other action has been obtained.

What are the implications and consequences of adhering to the Bail-in Protocol?

As described above, BRRD Entities must comply with the obligations imposed by the BRRD and in particular (excluding subparagraph (e) in the above definition) with Article 55, which requires BRRD Entities (excluding subparagraph (e) in the above definition) to include a contractual term in agreements creating any relevant liability governed by a third country law.

The Bail-in Protocol aims to permit Protocol BRRD Entities to comply with the Article 55 requirement in relation to their Covered ISDA Master Agreements and Covered Other Agreements. The Bail-in Protocol enables Adhering Parties to amend the terms of each such Protocol Covered Agreements to reflect the requirements of Article 55 of the BRRD.

It is important to note that the Bail-in Protocol only covers jurisdictions that have published implementing legislation with respect to Article 55 of the BRRD at the time the Bail-in Protocol was drafted, i.e. The Netherlands, France, Germany, Ireland, Italy, Luxembourg, Spain and the UK (each a "**Relevant Jurisdiction**"). Therefore, the Bail-in Protocol does not impact on any jurisdictions which are not a Relevant Jurisdiction.[67]

The Bail-in Protocol will incorporate into each Covered Protocol Agreement a provision whereby the parties acknowledge and accept that the liabilities arising under the relevant Protocol Covered Agreement may be subject to the exercise of bail-in by the RA of the Relevant Jurisdiction. In particular, with effect from the Implementation Date, each Protocol Covered Agreement will incorporate the document defined in the Bail-in Protocol as "the Attachment"). In particular, the Attachment contains the contractual recognition that the liabilities arising under the relevant derivative contract may be subject to the exercise of bail-in.

In order to capture the Relevant Jurisdictions, you will note that in Schedule 4 there are references to Dutch Regulations, French Regulations, German Regulations, Irish Regulations, Italian Regulations, Luxembourg

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(a) entered into alternative written arrangements that document the substance of the issues covered in the Attachment to the Bail-in Protocol (including the case where a Protocol Covered Agreement already includes a provision documenting the substance of the issues covered in the Attachment); or

(b) expressly stated in such agreement or otherwise agreed in writing that the Bail-in Protocol shall not apply, then, in either case,

such agreement shall not be a Protocol Covered Agreement.

[67] Please note that on 19 April 2017, ISDA announced the launch of a second Bail-in Protocol to help market participants meet the requirements of Article 55 under the BRRD. The second Bail-in Protocol will allow Austrian, Belgian, Danish and Swedish in-scope entities to meet the requirements of Article 55 of the BRRD. This extends coverage to 12 countries, following the launch of the Bail-in Protocol.

Regulations, Spanish Regulations and UK Regulations. Each of these definitions contains specific references to the relevant domestic law of each Relevant Jurisdiction.

Does the Bail-in Protocol capture affiliates of the counterparty or only the entity that adheres to the Bail-in Protocol?

No. The Bail-in Protocol captures only Protocol Covered Agreements entered into between two Adhering Parties. Affiliates will also need to adhere to the Bail-in Protocol.

Does the Bail-in Protocol apply to existing agreements prior to the Adherence Letter or only to agreements entered into after such date?

The Bail-in Protocol will only capture the Protocol Covered Agreements entered into by the Adhering Parties on or prior to the Implementation Date provided that such agreements are governed by the law of a non-EU member state (or, if the implementation of Article 55 of the BRRD in the relevant jurisdiction extends to liabilities governed by non-EEA law, such agreements are governed by non-EEA law). Future Protocol Covered Agreements will not be amended unless the parties agree bilaterally to make them subject to the terms of the Bail-in Protocol[68].

Does the status of the liabilities change if a party adheres to the Bail-Protocol?

No. Article 55 states that if a BRRD Entity fails to include the contractual acknowledgement required under Article 55, such failure will not prevent the RA from exercising its bail-in powers in relation to that liability. Therefore, whether a party adheres or not to the Bail-in Protocol will not change the BRRD status of the relevant liabilities.

If I am a third country entity, do I need to adhere?

If a third country entity decides not to adhere to the Bail-in Protocol, any existing ISDA Master Agreement (and/or any other relevant agreement subject to a third country law) entered into with BRRD Entity counterparties will not be BRRD compliant and its BRRD Entity counterparties will be in breach of Article 55. Provided that the liabilities that arise out of the agreement with its BRRD Entity counterparties are “bail-inable”, its BRRD Entity counterparties will need to comply with Article 55. So failure to of the third country entity to adhere to the Bail-in Protocol will not affect the third country entity directly but its BRRD Entities counterparties will be directly affected.

Article 30 of the EMIR Margin Rules and the Covered Bond Exemption

Introduction

The new rules that implement the margin requirements under the risk mitigation obligations as set out in EMIR, create a specific regime for hedging arrangements that are entered into in relation to covered bonds. This article discusses the main aspects of the covered bond exemption and its legal and practical implications.

Background

Covered bonds (each a “**CB**”), being securities issued by financial institutions (each a “**CB Issuer**”) pursuant to legislative CB regimes that are secured by pools of collateral, have become one of the largest growing asset classes in the European bond market and an important source of finance for mortgage lending. The defining feature of CBs is the dual nature of protection offered to investors, i.e. CB bondholders have direct recourse to the cover pool typically composed of mortgage loans or public-sector debt as preferred creditors, while remaining entitled to a claim against the CB Issuer as ordinary creditors for any residual amounts not fully settled with the liquidation of the cover pool.

Article 11 of Regulation No 648/2012 of the European Parliament and of the Council ("**EMIR**") requires FCs and NFC+s to have in place risk management procedures to ensure the timely, accurate and appropriately segregated exchange of collateral in connection with non-cleared OTC derivatives. This legal framework has been further developed by Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 (“**Margin RTS**”). On 15 December 2016, the Margin RTS was published in the Official Journal and entered into force on 4 January 2017.

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[68] To do so, parties may consider including language in their relevant document (i.e. ISDA Schedule, long form confirmation, etc.) that incorporates the Bail-in Protocol by reference.

The Covered Bond Exemption

Specific treatment in the Margin RTS is provided for OTC derivatives entered into in connection with CBs. The rationale behind this special treatment is the legal impediments that CB Issuers or cover pools may encounter when providing collateral. The main legal impediment is that variation margin ("**VM**") transfers may be considered a preference that ranks senior to CB holder claims. On the other hand, there are no constraints on a CB Issuer or cover pool returning cash previously posted to it as VM by a hedging bank counterparty to an OTC derivative. VM posting by a hedging bank counterparty to an OTC derivative with a CB Issuer upon its downgrade below certain triggers is also a requirement in rating agency criteria for CBs.[69] Therefore, Article 30(1) of the Margin RTS provides that, subject to satisfaction of a set of requirements listed in Article 30(2) of the Margin RTS (the "**CB Requirements**"), CB Issuers or cover pools are not required to post collateral (the "**Covered Bond Exemption**").

Article 30 of the Margin RTS sets outs the Covered Bond Exemption for CB Issuers and cover pools which exempts CB Issuers from posting any initial margin ("**IM**") and VM.

The Covered Bond Exemption will apply to CB Issuers or cover pools *provided* that all of the following CB Requirements are met		
1	No insolvency termination	the OTC derivative contract is not terminated in case of resolution or insolvency of the CB Issuer or cover pool[70]
2	*Pari Passu* with CB holders	hedging banks rank at least *pari passu* with the CB holders except where the relevant hedging bank is the defaulting or the affected party[71] or waives the *pari passu* ranking
3	Registration in the cover pool	the OTC derivative contract is registered or recorded in the cover pool of the CB in accordance with national CB legislation
4	Cover pool hedging	the OTC derivative contract is used only to hedge the interest rate or currency mismatches of the cover pool in relation to the CB
5	Only OTC derivatives related to CBs	the netting set does not include OTC derivative contracts unrelated to the cover pool of the CB Issuer
6	Eligible collateral of the CBs	the CB to which the OTC derivative contract relates is collateralised by any of the following eligible assets (as further described in paragraphs (1), (2) and (3) of Article 129 of Regulation (EU) No 575/2013): • exposures to or guaranteed by central governments, central banks that belong to the European System of Central Banks, public sector entities, regional governments or local authorities in the EU • exposures to or guaranteed by third country central governments, third-country central banks, multilateral

69 Unilateral collateral posting is also one of the main reasons why CB swaps may not be cleared through a clearing house.

70 This requirement rests on a fundamental feature of the CB market, its double recourse nature (i.e. CB holders have claims against the CB Issuer and the cover pool). In the event of an insolvency of the CB Issuer the hedging arrangements must remain in place since payments will be made out of the cover pool.

71 The wording "*except where the relevant hedging bank is the defaulting or the affected party*" is a consequence of a so-called flip cause which triggers the loss of the senior ranking in the priority order when the hedging bank counterparty is in default. If such flip clause applied, condition (2) above could otherwise not be met, hence the foregoing qualification.

		development banks, certain international organisationsand exposures to or guaranteed by third-country public sector entities, third- country regional governments or third-country local authorities that are risk weighted as exposures to institutions or central governments and central banks in accordance with the Regulation (EU) No 575/2013 • exposures to institutions that qualify for certain credit quality in accordance with the Regulation (EU) No 575/2013
7	Minimum overcollateralization	the cover pool of the CB to which the OTC derivative contract relates is subject to a regulatory collateralisation requirement of at least 102 %

Hedging Structure under CB Transactions

The hedging arrangements of a CB issuance are usually structured by entering into:

(a) a front swap transaction entered into by the CB Issuer and the relevant hedging bank counterparty (which hedges the exposure to interest rate or currency mismatches of the cover pool); and

(b) a back swap transaction entered into by the CB Issuer and the relevant hedging bank counterparty (which hedges the exposure of the CB Issuer and the hedging bank to free assets).

Front Swap

The Covered Bond Exemption only applies in respect of the front swap transaction (assuming satisfaction of all of the CB Requirements). Importantly, CB Issuers incorporated in jurisdictions where OTC derivative contracts are not registered or recorded in a cover pool register or where no overcollateralization requirement applies will not benefit from the Covered Bond Exemption.

The Covered Bond Exemption (i.e. no posting of IM or VM) applies only to CB Issuers or cover pools such that hedging bank counterparties to CB Issuers will have to post VM in cash only in accordance with the Margin RTS, daily and from the effective date of the transaction.

VM can only be posted in cash (so the list of eligible collateral set out in Article 4 of the Margin RTS will not apply and parties cannot deliver any securities).

Back Swap

The back swap transaction will not benefit from the Covered Bond Exemption, since not all CB Requirements will be met.

It follows that back swaps that are entered into in respect of front swaps relating to a CB issuance will be subject to the general EMIR margin framework. Therefore, VM posting will be bilateral and in addition, the parties will need to establish whether IM posting requirements apply and comply if indeed applicable.

Article 36 of the Margin RTS sets out the phase-in period of the IM obligation depending on the average notional amount of each party[72].

Hedging banks that face CB Issuers under the back swap will need certain disclosure from CB Issuers to understand when and if the obligation to post IM comes into force.

[72]
4 February 2017	IM: If aggregate month-end notional amount is greater than €3 trillion
1 September 2017	IM: If aggregate month-end notional amount is greater than €2.25 trillion
1 September 2018	IM: If aggregate month-end notional amount is greater than €1.5 trillion
1 September 2019	IM: If aggregate month-end notional amount is greater than €0.75 trillion
1 September 2020	IM: If aggregate month-end notional amount is greater than €8 billion

In addition, a consequence of the normal regulatory treatment will be that parties are not restricted to cash collateral in respect of the collateral they are permitted to post and may make use of the broader asset classes of collateral that the Margin RTS allows.

In relation to any existing CB hedging it is worth noting that counterparties may continue to apply their current risk management procedures they have in place provided that the relevant OTC derivative contracts were entered into between 16 August 2012 and the relevant dates of application of the Margin RTS[73]. Therefore, counterparties are not required to effect changes in respect of such existing transactions. Margin RTS VM obligations apply as of 1 March 2017 whereas IM will be phased-in in accordance with Article 36 of the Margin RTS.

The traditional discretion of parties to include bespoke features[74] in their back swap documentation (since they are not subject to rating agency criteria) may now be more limited since they will need to comply with the Margin RTS. Parties will carefully need to assess whether any bespoke provision may interact with or affect any of their EMIR margin obligations. Parties are free to include any features or specific wording as long as they remain EMIR-compliant.

Rating Agency Criteria

To date, risk mitigation in swaps relating to CB issuances has been driven in part by rating agency criteria. The main difference between the EMIR margin obligations and the rating criteria insofar as it applies to such swaps is that that the requirement to post collateral in the latter case only applies once the hedging bank is downgraded below the "first trigger". VM posting from the effective date of the transaction should not contradict these triggers. No rating criteria in respect of swap counterparties in CB issuances have been modified as yet and since EMIR generally and the Margin RTS specifically provide a stricter regime for collateral posting, it is not entirely clear whether we should expect changes in the near future.

CB Swaps – Main aspects to consider

	Front Swap	Back Swap
Obligation to post IM	Not applicable to either party	Applicable to both parties provided that each party satisfies the thresholds requirements set out in Article 36 Margin RTS
Obligation to post VM	Only the hedging bank	Both parties
Eligible collateral	Only cash	Any Eligible Collateral set out in Article 4 Margin RTS
Minimum Transfer Amount	EUR 500,000	EUR 500,000
Valuation Frequency	Daily	Daily
Independent Amount	Not applicable to CB Issuer but non-regulatory Independent Amount may apply to the hedging bank	Subject to the relevant thresholds as specified in Article 36 Margin RTS and in any case, it must be calculated in accordance with the IM models satisfying the requirements set out in Article 14 Margin RTS

[73] See above dates and Article 36 Margin RTS.

[74] For example, exposure calculation based on reference trade, longer periods for collateral postings, return pass through features between the swaps, etc.

MiFID II / MiFIR Update

Reporting Obligation (Article 26 of MiFIR / RTS 22)

- **28 July 2016** – European Commission adopted Delegated Regulation supplementing Regulation (EU) No 600/2014 of the European Parliament and of the Council with regard to regulatory technical standards for the reporting of transactions to competent authorities ("**RTS 22**").

- **15 September 2016** - European Parliament extended the objection period to 22 November 2016 (rather than 22 October 2016 as proposed by Commission) prior to publication in the Official Journal as it was of the view that the European Commission has made more than typographical changes to the ESMA draft RTS.

- **10 October 2016** - ESMA Guidelines on Transaction reporting, order record-keeping and clock synchronisation under MiFID II published.

- **26 October 2016** – ESMA Technical Reporting Instructions, MiFIR Transaction Reporting published.

- **30 November 2016** - European Parliament announced its non-objection to final draft.

- RTS 22 to be published in the Official Journal.

"Ancillary Activity" Exemption for Commodity Firms (RTS 20)

- 30 March – Commission Delegated Regulation supplementing Directive 2014/65/EU of the European European Parliament and of the Council with regard to regulatory technical standards for the criteria to establish when an activity is considered to be ancillary to the main business ("**RTS 20**") published in the Official Journal.

- RTS 20 will take effect on 3 January 2018.

Commodity Position Limits (Article 57 of MiFID II / RTS 21)

- **28 September 2015** - ESMA submitted draft RTS on the methodology for the calculation and the application of position limits for commodity derivatives traded on trading venues and economically equivalent OTC contracts ("**RTS 21**") to the European Commission pursuant to Article 10(1) of Regulation No (EU) 1095/2010 and Articles 57(3) and (12) MiFID II.

- **17 March 2016** - Markus Ferber MEP (Parliament's Rapporteur for MiFID II), stated the European Commission has sent back draft RTS to ESMA to revise them. Concern that the RTS need to take into account Parliament's position more thoroughly:

"Especially the position limits regime urgently needs a comprehensive redrafting in order to effectively curb food speculation."

- **20 April 2016** - European Commission notified ESMA of its intention to endorse draft RTS 21 subject to a number of changes.

- **2 May 2016** - ESMA published Opinion (ESMA/2016/668) proposing amendments to its draft RTS 21.

- **1 December 2016** – European Commission published RTS 21 which is subject to a scrutiny period of three months by the European Parliament and the Council of the European Union.

- **19 December 2016** – ESMA Q&A re. MiFID II and MiFIR commodity derivatives topics published.

- **30 March** – RTS 21 published in the Official Journal.

- RTS 21 will take effect on 3 January 2018.

Trading Obligation (Articles 28 & 32 of MiFIR / RTS 5)

- **20 September 2016** - ESMA published a discussion paper seeking stakeholder's feedback on the options put forward by ESMA on how to calibrate the trading obligation.

- MiFIR foresees two tests to determine the trading obligation:

    The venue test: a class of derivatives must be admitted to trading or traded on at least one admissible trading venue; and

    The liquidity test: whether a derivative is 'sufficiently liquid' and there is sufficient third-party buying and selling interest.

- The discussion paper includes options on how to determine the trading obligation by applying both tests, including an initial liquidity assessment on the basis of trading data for the six month to the end of 2015.
- The consultation closed on 21 November 2016.
- **13 June 2016** - European Commission adopted further Delegated Regulations under MiFID II/MiFIR on direct, substantial and foreseeable effects of derivative contracts within the EU and the prevention of the evasion of rules and obligations ("**RTS 5**").
- **19 November 2016** - RTS 5 was published in the Official Journal.
- **9 December 2016** – RTS 5 entered into force.

UK Implementation

- **29 July 2016** - FCA published a second set of implementation proposals for MiFID II (CP16/19). This CP followed on from CP15/43, published in December 2015.
- In particular, the FCA proposed a new section of the Market Conduct Sourcebook to set out guidance and directions on the MiFID II regime for position limits, position management and position reporting for commodity derivatives contracts.
- The consultation closed on 28 October 2016. A policy statement is expected to follow in Spring 2017.
- **29 September 2016** - The FCA has published its third consultation paper (CP16/29) on the implementation of MiFID II.
- In particular, MiFID II rules relating to structured deposits will be put into COBS (relating to e.g. inducement rules and independence standard for personal recommendations to retail clients in the UK).
- The consultation closed on 31 October 2016 for chapter 16 and 4 January 2017 for all other chapters.
- **27 October 2016** – The PRA published policy statement PS29/16 which provides feedback to responses to the FCA's Consultation Paper CP9/16 "Implementation of MiFID II: Part 1".
- **16 December 2016** - The FCA has published its fourth consultation paper (CP16/43) on the implementation of MiFID II.
- The consultation closed on 16 January 2017 for chapter 7 and 17 February 2017 for all other chapters.
- **31 March 2017** - FCA published its first policy statement implementing MIFID II/MIFIR. The policy statement sets out our near final rules in the areas consulted on in CP15/43 CP16/19 and covers some issues consulted on in CP16/29 and CP16/43.
- **28 April 2017** - The PRA published policy statement PS9/17 which provides final policy following the FCA's Consultation Paper CP16/43 "Implementation of MiFID II: Part 2".

ESMA Q&As

- **5 April 2017** - ESMA published Q&As on MiFID II and MiFIR commodity derivatives topics.
- **5 April 2017** - ESMA published Q&As on MiFID II and MiFIR transparency topics.
- **5 April 2017** - ESMA published Q&As on MiFID II and MiFIR market structures topics.

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