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In this issue of The Delta Report, we bring you further updates on developments in the global derivatives space. In Europe, the focus is on Brexit and the newly-released EU final regulatory standards on the valuation of derivatives for the purpose of bail-in. We also highlight recent rulings of the US Bankruptcy Court and German Federal Court which impact CDO transactions and netting clauses under German law respectively. Across the globe, we continue to provide insight to the latest regulatory developments.

Developments in the Americas

CFTC Approves Final Rule Removing Trade Option Reporting and Recordkeeping Requirements for Commercial End Users

*On March 16, 2016, the Commodity Futures Trading Commission (“**CFTC**”) approved a final rule (“**TO Final Rule**”)[1] that amends its trade option exemption regulation by eliminating reporting and recordkeeping requirements for trade option counterparties that are not swap dealers (“**SD**”) or major swap participants (“**MSP**”).*

Background

Commodity options constitute “**swaps**” under Section 1a(47) of Commodity Exchange Act (the “**CEA**”) and must be in compliance with rules or regulations applicable to any other swap. However, the CFTC provides for exemption from many of such requirements if a commodity option transaction meets the following requirements (“**trade option exemption**”):

(a) it is offered by either an eligible contract participant (“**ECP**”) or a producer, processor, commercial user of, or merchant handling the commodity that is the subject of the commodity option transaction, or the products or byproducts thereof (a “**commercial party**”) that offers or enters into the commodity option transaction solely for purposes related to its business as such;

(b) it is offered to (and the offeror reasonably believes that it is offered to) a commercial party solely for purposes related to its business as such; and

(c) the option is intended to be physically settled so that, if exercised, the option would result in the sale of an exempt or agriculture commodity for immediate or deferred shipment or delivery.

Commodity options that fall within the trade option exemption are generally exempt from rules and regulations otherwise applicable to swaps.

However, prior to the TO Final Rule, trade options that met the trade option exemption were still subject to reporting requirements pursuant to part 45 of CFTC regulations if at least one of the non-SD/MSP counterparties had become obligated to comply with part 45 reporting requirements in the preceding 12-month period in connection with a non-trade option swap trading activity.

If neither counterparty to a trade option had been obligated to report pursuant to part 45, each counterparty to an otherwise unreported trade option was required to submit an annual Form TO to the CFTC, providing notice that the counterparty has entered into unreported trade option(s) during the prior calendar year.

The CFTC had provided some regulatory relief to commercial participants through CFTC No-Action Letter No. 13-08, which expanded eligibility to submit Form TO in lieu of reporting commodity option transactions under part 45, if the party that would have otherwise been required to report trade options is a non-SD/MSP. The party was also required to notify the CFTC Division of Market Oversight (“**DMO**”) within 30 days of entering into trade options having an aggregate notional value of $1 billion during any calendar year.

Counterparties to trade options that met the trade option exemption were also subject to swap data recordkeeping requirements of part 45, as otherwise applicable to any other swap.

In an effort to ease the burden of commercial end users, in April 2015, the CFTC issued a proposal to reduce the reporting and recordkeeping requirements applicable to trade option counterparties that are non-SD/MSPs (“**TO Proposal**”).[2]

The Final Rule

The TO Final Rule removes reporting requirements for non-SD/MSP trade option counterparties altogether, whether under part 45 or through Form TO. The use of Form TO has been completely eliminated. The CFTC also declined to adopt the notice requirement that was part of the TO Proposal, where non-SD/MSPs that enter into trade options that have (or is expected to have) an aggregate notional value over $1 billion in any

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1 Trade Options, 81 FR 14966 (March 21, 2016).

2 Notice of Proposed Rulemaking, 80 FR 26200 (May 7, 2015).

calendar year had to notify the DMO. The CFTC stated that the data would have provided limited surveillance and oversight value that was not commensurate to market participants' difficulty in tracking and valuing trade options.

The TO Final Rule also eliminates recordkeeping requirements for trade option counterparties that are non-SD/MSPs. Here again, the TO Final Rule went further than the TO Proposal, which would have still required the non-SD/MSP counterparties to comply with applicable recordkeeping provisions of CFTC regulation §45.2. Though when transacting trade options with SD/MSPs, non-SD/MSP counterparties must obtain and provide a legal entity identifier.

The TO Final Rule also made a technical amendment to §32.3(c), deleting a reference to part 151 position limits, which has been vacated. The CFTC also stated that "federal speculative position limits should not apply to trade options" and that the matter would be addressed in the context of future position limit rulemaking.

CFTC No-Action Letter No. 13-08 is no longer applicable and was withdrawn as the TO Final Rule took effect.

CFTC Issues Final Rules on Cross-Border Uncleared Swap Margin Requirements

The CFTC has combined an entity-level approach with a transaction-level approach in its final cross-border uncleared swap margin requirements.

Introduction

On 16 December 2015, the Commodity Futures Trading Commission (the "**CFTC**") released final rules and accompanying interpretive guidance setting out the CFTC's initial and variation margin requirements applicable to uncleared swaps ("**CFTC Final Margin Rules**").[3] On May 24, 2016, the CFTC released final rules and accompanying interpretative guidance setting forth the application of the CFTC Final Margin Rules to cross-border swap transactions (the "**CFTC Final Cross-Border Margin Rules**").[4]

We set out below a brief summary of these rules. For a more detailed explanation, please see our client alert on these rules available here. For information on the final margin rules for uncleared swaps of the CFTC and the Prudential Regulators[5] (including the cross-border rules of the Prudential Regulators), please see our client alert available here.

Each use of the term "**CSE**" herein refers only to registered SDs and MSPs subject to the CFTC Final Margin Rules and the CFTC Final Cross-Border Margin Rules.

Entity Classification

Under the CFTC Final Cross-Border Margin Rules, how the CFTC Final Margin Rules would apply to a particular CSE will depend on that entity's classification as well as the classifications of its counterparties. The relevant classifications are:

(a) U.S. person;

(b) Non-U.S. person guaranteed by a U.S. person;

(c) U.S. branch of a non-U.S. person; and

(d) Foreign Consolidated Subsidiary.

Determining whether an entity falls within one of the above classifications will be a matter of applying the three key definitions set out in the CFTC Final Cross-Border Margin Rules, being "**U.S. person**", "**Guarantee**" and "**Foreign Consolidated Subsidiary**". The definitions of these terms and their applicability to the entity classifications are briefly described below.

U.S. person

The definition of "**U.S. person**" for the purposes of the CFTC Final Cross-Border Margin Rules is as follows:

(i) Any natural person who is a resident of the United States;

(ii) Any estate of a decedent who was a resident of the United States at the time of death;

(iii) Any corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of entity similar to any of the foregoing (other than an entity described in subparagraph (iv) or (v)) (a legal entity), in each case that is organized or incorporated under the laws of the United States or having its principal place of business in the United States, including any branch of the legal entity;

(iv) Any pension plan for the employees, officers or principals of a legal entity described in subparagraph (iii), unless the pension plan is primarily for foreign employees of such entity;

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[3] 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.

[4] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements, 81 FR 34817 (May 31, 2016), available at https://federalregister.gov/a/2016-12612.

[5] 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.

(v) Any trust governed by the laws of a state or other jurisdiction in the United States, if a court within the United States is able to exercise primary supervision over the administration of the trust;

(vi) Any legal entity (other than a limited liability company, limited liability partnership or similar entity where all of the owners of the entity have limited liability) owned by one or more persons described in subparagraph (i), (ii), (iii), (iv) or (v) who bear(s) unlimited responsibility for the obligations and liabilities of the legal entity, including any branch of the legal entity; and

(vii) Any individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in subparagraph (i), (ii), (iii), (iv), (v) or (vi).

Guaranteed by a U.S. person

The definition of "**guarantee**" under the CFTC Final Cross-Border Margin Rules is an arrangement pursuant to which a party to an uncleared swap transaction with a counterparty that is a non-U.S. person has a legally enforceable right of recourse (whether conditional or unconditional) against at least one U.S. person (irrespective of any affiliation with the counterparty) with respect to the counterparty's obligations under the uncleared swap transaction.

The CFTC will permit a party to reasonably rely on its counterparty's written representation in determining whether or not such counterparty is guaranteed by a U.S. person, absent any indications to the contrary.

Foreign Consolidated Subsidiary

This term captures any CSE that is not a U.S. person in which an ultimate parent entity that is a U.S. person has a controlling interest, in accordance with U.S. GAAP, such that the ultimate parent entity includes the non-U.S. CSE's operating results, financial position and statement of cash flows in its consolidated financial statements, in accordance with U.S. GAAP. A party that is not a CSE cannot be a Financial Consolidated Subsidiary, even if it is consolidated with a U.S. ultimate parent entity.

Substituted Compliance

Should substituted compliance be granted with respect to some or all of a foreign jurisdiction's uncleared swap margin requirements, then CSEs will be entitled in the circumstances set out in the table below to comply with the foreign jurisdiction's uncleared swap margin requirements in order to satisfy the CFTC's requirements. This will be permitted to the extent of the substituted compliance determination. CSEs will remain subject to the CFTC's examination and enforcement authority.

Application of the CFTC Final Margin Rules

As mentioned above, the classifications of the counterparties to a particular uncleared swap will determine the extent to which the CFTC Final Margin Rules will apply to cross-border swap transactions. The possible outcomes fall into the following five categories which have been color-coded to correspond to the cells in the below table.

We remind you that each use of the term "**CSE**" in the table refers only to registered SDs and MSPs subject to the CFTC Final Margin Rules. Should an uncleared swap be entered into with a SD or MSP that is subject to regulation by a Prudential Regulator, the outcome may be different than that set out in the below table. The requirements of the Prudential Regulator's initial and variation margin requirements must be considered.

Apply	CFTC Final Margin Rules apply and substituted compliance is not available.
Apply with Partial Substituted Compliance (Initial Margin Collection)	A CSE would benefit from a substituted compliance determination, if available, with respect to initial margin collected from its counterparty. This only applies where the counterparty is a CSE that is a U.S. person or a non-U.S. person whose swaps are guaranteed by a U.S. person. The CFTC Final Margin Rules would still apply (i) to initial margin collected by a CSE from its counterparty to the extent not covered by the substituted compliance determination, (ii) to initial margin posted by a CSE to its counterparty and (iii) to all variation margin requirements.
Apply with Partial Substituted Compliance (Initial Margin Posting)	A CSE would benefit from a substituted compliance determination, if available, with respect to initial margin posted to its counterparty. The counterparty cannot be a U.S. person or a non-U.S. person whose swaps are guaranteed by a U.S. person. Also, the counterparty must be subject to a foreign jurisdiction's margin requirements. The CFTC Final Margin Rules would still apply (i) to initial margin posted by a CSE to its counterparty to the extent not covered by the substituted compliance determination, (ii) to initial margin collected by a CSE to its counterparty and (iii) to all variation margin requirements.
Apply with Full Substituted Compliance	A CSE would benefit from a substituted compliance determination, if available, with respect to all the CFTC Final Margin Rules.
Do Not Apply	The CFTC Final Margin Rules do not apply. In these circumstances it is likely that a foreign jurisdiction's uncleared swap margin requirements will apply. This exclusion does not apply to an uncleared swap of a non-U.S. CSE where (i) that swap is not covered by a substituted compliance determination with respect to the initial margin requirements in the relevant jurisdiction and (ii) any of the risks associated with that swap are transferred directly or indirectly, through inter-affiliate swap transactions, to a U.S. CSE (or a non-U.S. CSE that is guaranteed by a U.S. person).

			CSE				
			U.S. Person	Non-U.S. Person			
			All	Guaranteed	U.S. Branch	Foreign Consolidated Subsidiary	Other
CSE Counterparty	U.S. Person	All	Apply	Apply	Apply with Partial Substituted Compliance (Initial Margin Collection)	Apply with Partial Substituted Compliance (Initial Margin Collection)	Apply with Partial Substituted Compliance (Initial Margin Collection)
	Non-U.S. Person	Guaranteed	Apply	Apply	Apply with Partial Substituted Compliance (Initial Margin Collection)	Apply with Partial Substituted Compliance (Initial Margin Collection)	Apply with Partial Substituted Compliance (Initial Margin Collection)
		U.S. Branch	Apply with Partial Substituted Compliance (Initial Margin Posting)	Apply with Partial Substituted Compliance (Initial Margin Posting)	Apply with Full Substituted Compliance	Apply with Full Substituted Compliance	Apply with Full Substituted Compliance
		Foreign Consolidated Subsidiary	Apply with Partial Substituted Compliance (Initial Margin Posting)	Apply with Partial Substituted Compliance (Initial Margin Posting)	Apply with Full Substituted Compliance	Apply with Full Substituted Compliance	Apply with Full Substituted Compliance
		Other	Apply with Partial Substituted Compliance (Initial Margin Posting)	Apply with Partial Substituted Compliance (Initial Margin Posting)	Apply with Full Substituted Compliance	Apply with Full Substituted Compliance	Do Not Apply
Non-CSE Counterparty	U.S. Person	All	Apply	Apply	Apply with Full Substituted Compliance	Apply with Full Substituted Compliance	Apply with Full Substituted Compliance
	Non-U.S. Person	Guaranteed	Apply	Apply	Apply with Full Substituted Compliance	Apply with Full Substituted Compliance	Apply with Full Substituted Compliance
		Other	Apply with Partial Substituted Compliance (Initial Margin Posting)	Apply with Partial Substituted Compliance (Initial Margin Posting)	Apply with Full Substituted Compliance	Apply with Full Substituted Compliance	Do Not Apply

Implementing Dodd-Frank: Current Status of SEC Mandatory Rulemaking

Introduction

Multiple sections of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") contain a provision requiring the SEC to implement rules regarding the subject matter addressed therein. Through these rulemaking provisions, the SEC has "increased transparency, better investor protections and new regulatory tools" that serve to create "a stronger marketplace and financial future for all Americas".[6]

To date, the SEC has taken action to address many of these rulemaking provisions, and of July 2016, the SEC has adopted final rules for 78% of the rulemaking provisions required under the Dodd-Frank. As we continue to receive inquiries from clients regarding the status of the SEC's rulemaking process regarding different requirements, we thought it useful to provide an interim update.

The SEC tracks its rulemaking status on its website,[7] where it provides an overview of the rules enacted, as well as an overview of the new regulatory oversight departments that have been created together with the studies that have been undertaken by these departments, all as required in connection with its implementation of the Dodd-Frank Act.

Although the rulemaking process is ongoing, the SEC has adopted or proposed specific rules with respect to each of the following categories:

We set forth below a summary of the adopted and proposed rules with respect to each category.

<u>Private Funds</u>

In the private funds category, the SEC has adopted the following rules:

Section	Summary of Rule Adopted
404 and 406	Requires advisors to hedge funds and private funds to maintain and report certain information to the SEC and CFTC
407 and 408	Defines "**venture capital firm**" and provides an exemption from registration for venture capital firms and private fund advisers managing less than $150 million in private funds
409	Defines "**family office**" for purposes of excluding individuals that manage their own family's financial portfolios from being deemed an "**investment advisor**" and subject to the Investment Advisers Act
410	Provides for the transaction of mid-sized investment advisors (i.e., individuals or entities that manage between $25 million and $100 million in assets) from regulation by the SEC to state regulation
413	Revises the standard for determining status as an "**accredited investor**" for purposes of investing in unregistered securities offerings to exclude the value of an individual's home from net worth calculations
418	Modifies threshold for determining status as a "**qualified client**" of a registered investment advisor

The SEC has adopted final rules for all rulemaking provisions required under the Dodd-Frank Act with respect to the regulation of private funds.

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[6] Mary Jo White, Public Statement, *Statement on the Anniversary of the Dodd-Frank Act* (June 2015), http://www.sec.gov/news/statement/statement-on-the-anniversary-of-the-dodd-frank-act.html

[7] Securities and Exchange Commission, *Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act* (July 2016), https://www.sec.gov/spotlight/dodd-frank.shtml.

Volcker Rule

In the Volcker Rule category, the SEC has adopted the following rule:

Section	Summary of Rule Adopted
619	Prohibits proprietary trading and certain interest is, and relationships with, hedge funds and private equity funds

In addition, the SEC has adopted the following interim rule:

Section	Summary of Rule Adopted
619	Provides an exception from prohibited relationships for banking entities that retain an interest in certain types of collateralized debt obligations that are backed primarily by trust preferred securities

The SEC has adopted final rules for the sole rulemaking provision required under the Dodd-Frank Act with respect to the Volcker Rule.

Security-Based Swaps

In the security-based swaps category, the SEC has adopted the following rules:

Section	Summary of Rule Adopted
712	Adopts rules regarding derivatives products, including a definition for mixed swaps (among other swaps-related definitions), as well as specific recordkeeping requirements for trade repositories, swap dealers, security-based swap dealers, major swap participants and security-based swap participants* * Rule jointly published with the Commodity Futures Trading Commission
761	Adopts rules regarding swap market intermediaries, including identification of major security-based swap participants and an exemption from the definition of security-based swap dealer for "***de minimis***" activity
763	Adopts rules regarding clearing agencies and security-based swap repositories: (a) the clearing process regarding security-based swaps (including staying a clearing requirement and review of transactions approved for clearing, prevention of evasion of clearing requirements and transition reporting rules) (b) governance rules and duties (c) collection and public availability of security-based swap transaction and pricing data
764	Adopts rules with respect to security-based swap dealers and security-based major swap participants, including: (a) registration requirements (b) applicable business conduct standards (c) documentation requirements (d) duties, including requirements regarding risk management procedures, disclosure of general information, ability to obtain information, conflicts and antitrust
766	Adopts transition rules regarding reporting security-based swap transactions entered into prior to enactment of Dodd-Frank, as well as rules regarding reporting of uncleared security-based swap transactions

In addition, the SEC has proposed the following final rules (which have yet to be adopted):

Section	Summary of Rule Proposed
763	Proposes general rules and rules regarding data collection and reporting for security-based swap execution facilities, ,as well as rules regarding fraudulent activity with respect to security-based swaps
764	Proposes reporting and recordkeeping requirements for security-based swap dealers and security-based major swap participants, including daily trading recordkeeping requirements, capital and margin requirements (for non-bank security-based swap dealers and security-based major swap participants)
765	Proposes conflicts of interest rules for security-based swap dealers and security-based major swap participants
766	Proposes specific recordkeeping requirements for certain types of security-based swaps

Clearing Agencies

In the clearing agencies category, the SEC has adopted the following rules:

Section	Summary of Rule Adopted
805	Establishes authority of the SEC to prescribe risk management standards for designated clearing entities and provides minimum standards pertaining to governance and risk management practices of registered clearing agencies
806	Establishes process by which designated clearing agencies will provide notice of proposed changes to rules, procedures or operation of designated financial market utilities

The SEC has adopted final rules for all rulemaking provisions required under the Dodd-Frank Act with respect to the regulation of clearing agencies.

Municipal Securities Advisors

In the municipal securities advisers category, the SEC has adopted the following rules:

Section	Summary of Rule Adopted
975	Adopts rules regarding registration of municipal advisors, as well as approval of rules proposed by the Municipal Securities Rulemaking Board regarding standards of conduct and board membership.

The SEC has adopted final rules for the sole rulemaking provision required under the Dodd-Frank Act with respect to municipal advisors.

Executive Compensation

In the executive compensation category, the SEC has adopted the following rules:

Section	Summary of Rule Adopted
952	Adopts rules regarding the independence of Compensation Committees, including SEC to direct self-regulatory organizations to: (a) Direct self-regulatory organizations to prohibit listing of certain securities by issuers that do not comply with compensation committee independence requirements or other requirements under Section 10C of the Exchange Act

Section	Summary of Rule Adopted
	(b) Identify factors that could affect compensation committee independence
	(c) Issue rules regarding proxy disclosure of compensation consultants
953	Adopts rules regarding additional executive compensation disclosure with respect to pay ratio of chief executive officer to median compensation of employees
972	Adopts rules regarding disclosure of board leadership (including Chairman / Chief Executive Officer structure) in annual proxy statement

The SEC has also approved the following rule (in part).

Section	Summary of Rule Proposed
951	Adopts rules regarding shareholder approval of executive compensation and "**golden parachute**" compensation requirements

In addition, the SEC has proposed the following final rules (which have yet to be adopted):

Section	Summary of Rule Proposed
953	Proposes disclosure rules regarding pay versus performance of executives
954	Proposes rules regarding recovery of executive compensation
955	Proposes rules regarding disclosure of hedging activity by employees and directors
956	Proposes rules regarding disclosure of compensation structure and prohibition of certain compensation arrangements at certain financial institutions

Asset-Backed Securities

In the asset-backed securities category, the SEC has adopted the following rules:

Section	Summary of Rule Adopted
941	Adopts rules regarding credit risk retention (in general and with respect to residential mortgages) by securitizes of asset-backed securities, including certain exemptions to the credit risk retention rules
942	Adopts rules standardizing disclosure obligations with respect to asset-backed securities in certain asset classes, as well as suspension of reporting obligations for certain asset classes
943	Adopts rules regarding use of representations and warranties with respect to asset-backed securities
945	Disclosure of due diligence of asset-backed securities

In addition, the SEC has proposed the following final rule (which has yet to be adopted):

Section	Summary of Rule Proposed
621	Proposes rules to prohibit conflicts of interest in respect of certain securitization transactions

Credit Rating Agencies

In the credit rating agencies category, the SEC has adopted the following rules:

Section	Summary of Rule Adopted
932	Adopts rules regarding: (a) internal controls governing implementation of and adherence to policies and procedures for determining credit ratings (b) separation of ratings departments from sales and marketing departments (c) policies and procedures regarding look-back reviews (d) fines and penalties for certain violations (e) transparency of ratings performance (f) methodologies for credit rating (including form and certification) (g) certain rules regarding the use of third-parties that conduct due diligence in ratings process
936	Adopts rules regarding standards for training, experience and competence required for credit rating analysts
938	Adopts rules regarding universal ratings symbols

The SEC has also approved the following rules in part.

Section	Summary of Rule Proposed
939	Proposes rules regarding the removal of statutory references to the Investment Company Act and the Exchange Act regarding credit ratings and substitutes standards to be established by the SEC
939A	Proposes rules regarding the review of reliance on credit ratings with respect to a limited set of credit ratings in SEC statues, rules and forms that have not yet been addressed

Specialized Disclosures

In the specialized disclosures category, the SEC has adopted the following rules:

Section	Summary of Rule Adopted
1502	Adopts rules regarding disclosure of use of "**conflict minerals**" * * Rule currently under review by the U.S. Court of Appeals for the District of Columbia Circuit
1504	Adopts rules regarding disclosure by resource extraction issuers of payments to governments (domestic and foreign) related to commercial development in oil, gas or mineral resources industries

The SEC has adopted final rules for the sole rulemaking provision required under the Dodd-Frank Act with respect to municipal advisors.

Other

In the asset-backed securities category, the SEC has adopted following rules:

Section	Summary of Rule Adopted
916	Streamlines the procedural rules for filings by self-regulatory organizations
924	Implements whistleblower provisions under Section 21F of the Securities Act
926	Prohibits felons and other "**bad actors**" from offering or selling securities under Regulation D
929W	Revised rules regarding notice to missing security holders for delivery of dividends and interest
939B	Eliminated exemption for credit rating agencies from fair disclosure rule
989G	Conforms the Internal Control Audit Requirements for Smaller Companies such that that auditor attestation requirement does not apply to non-accelerated filers
1088	Requires investment companies and broker-dealers to adopt policies and procedures to prevent identity theft* * Rule issued jointly with the CFTC

In addition, the SEC has proposed the following final rule (which has yet to be adopted):

Section	Summary of Rule Proposed
205(h)	Proposes rules implementing orderly liquidation of covered brokers and dealers

The following final rules have not yet been addressed:

Section	Summary of Rule Proposed
165	Rules regarding tress tests
915	Rules regarding regulations of the Office of Investor Advocate
929X(a)	Rules regarding reform of short sales
984(b)	Rules to increase transparency of information available to brokers, dealers and investors with respect to lending or borrowing securities

CFTC and SEC Propose to Exclude Certain Electric Power Capacity and Natural Gas Peaking Contracts from "Swaps" Definition

On April 4, 2016, the Commodity Futures Trading Commission ("**CFTC**") and the Securities Exchange Commission jointly proposed guidance ("**Proposed Guidance**") relating to the exclusion of certain electric power and natural gas products from the definition of "**swap**" under the Commodity Exchange Act ("**CEA**"). Under the Proposed Guidance, (1) certain capacity contracts for electric power and (2) certain peaking supply contracts for natural gas would not be considered "**swaps**" under the CEA. The Proposed Guidance is complementary to the trade options final rule removing end-user reporting and record keeping requirements, all intended to reduce the burden for end-users addressing commercial risk in the derivatives market.

The Proposed Guidance is based on the CFTC final rule further defining the term "**swap**" (the "**Products Release**") in which customary commercial arrangements entered into by commercial or non-profit entities are considered not to be swaps.[8] The Products Release had provided a non-exhaustive list of specific contracts that constitute customary commercial arrangements (such as purchase and service contracts) and a list of characteristics and factors common to such agreements: (1) they do not contain payment obligations that are severable from the agreement; (2) they are not traded on an organized market or over the counter; and (3) are entered into by commercial or non-profit entities as principals (or by their agents) to serve an independent commercial, business or non-profit purpose, other than for speculative, hedging or investment purposes. Market participants had commented that certain products commonly used in the electric and natural gas markets meet the described factors and thus should not be regulated as swaps.

In the Proposed Guidance, the CFTC acknowledged the comments and stated its preliminary belief that the two contracts described below should be considered not to be swaps because they meet the interpretation of commercial arrangements set forth in the Products Release.

(a) Capacity contracts for electric power: These capacity contracts are used by load serving entities and load serving electric utilities to secure grid management and on-demand deliverability of power (pursuant to regulatory requirements from state public utility commissions). The initial payment covers the entire fixed cost of supplying the electric power, rather than separately paying an option premium and then the market price of electric power upon exercise of the option. These capacity contracts are treated by purchasers as a purchase of a supplier's capacity so as to ensure appropriate supply, rather than a purchase of a financial instrument or a hedge.

(b) Peaking Supply contracts for natural gas: These peaking supply contracts are entered into by electric utilities to purchase natural gas from another natural gas provider on days when its primary, local natural gas distribution companies have service disruptions due to regulatory commitments to prioritize residential gas demand. These contracts cannot be financially settled or re-sold. The exercise right to take delivery under these contracts are practically limited to events of service interruption.

The public comment for the Proposed Guidance is now closed. If the Proposed Guidance is adopted, the electric power and natural gas contracts described above would not be regulated as swaps.

8 Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 FR 48207, 48246 (Aug. 13, 2012).

US Bankruptcy Court Enforces CDO Transaction Flip Clauses

US Bankruptcy Court holds that insolvency-related provisions setting the priority of payment under various structured finance transactions were enforceable and the distributions were protected by the US Bankruptcy Code safe harbours.

Introduction

On 28 June 2016, the US Bankruptcy Court for the Southern District of New York (the "**Court**") decided, in *Lehman Brothers Special Financing Inc. v. Bank of America National Association, et al,*[9] that provisions set out in various synthetic collateralized debt obligation ("**CDO**") transactions that altered the priority of payments following the occurrence of certain specified insolvency events were enforceable and the distributions made under such provisions were protected by the US Bankruptcy Code safe harbours.

This Court declined to adopt the reasoning of Judge Peck in earlier rulings in the same case, in *Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Ltd. (In re Lehman Bros. Holdings Inc.)*[10] ("**BNY**") and *Lehman Brothers Special Financing Inc. v. Ballyrock ABS CDO 2007-1 Ltd. (In re Lehman Bros. Holdings Inc.)*[11] ("**Ballyrock**"), which invalidated similar CDO provisions that subordinated swap termination payments upon the occurrence of certain specified insolvency events.

This article sets out a summary of this decision.

The CDO Transactions

The transactions at issue were a series of CDO transactions. Although the CDO transactions had varied terms in certain respects, they all had the same general structure:

(a) An issuer issued one or more series of notes (the "**Notes**") to a group of noteholders (the "**Noteholders**") and used the proceeds to purchase certain liquid investments to provide investment income and serve as collateral (the "**Collateral**").

(b) The issuer entered into one or more swaps with Lehman Brothers Special Financing Inc. ("**LBSF**") whereby the issuer sold synthetic credit protection to LBSF on certain reference entities (each, a "**Swap**"). The issuer used the premium payments received from LBSF to enhance the interest payments to the Noteholders under the Notes.

(c) The Collateral was used to secure or support the issuer's obligations to the Noteholders under the Notes and to LBSF under the Swaps. The Collateral was held in trust by a trustee and the trustee held a lien on the Collateral for the benefit of the Noteholders, LBSF and other specified secured parties. All payments from the Collateral were to be made by the trustee pursuant to the priority of payment provisions that became the subject of the litigation.

(d) Lehman Brothers Holding Inc. ("**LBHI**") guaranteed LBSF's obligations under each Swap and was designated as a "credit support provider" under the Swaps documentation.

The Lehman Bankruptcies

On 15 September 2008 LBHI filed for bankruptcy protection ("**LBHI Petition Date**") and on 3 October 2008 LBSF filed for bankruptcy protection ("**LBSF Petition Date**"), in each case, under Chapter 11 of the US Bankruptcy Code.

As a result of LBHI bankruptcy petition filing, the payment obligations under the Notes were accelerated, the vast majority of the Swaps were terminated and the Collateral was liquidated and distributed in accordance with the priority of payment provisions (see below). Because LBHI was a "credit support provider" of LBSF under the Swaps, the bankruptcy filing of LBHI resulted in an event of default under the Swaps permitting the issuers to terminate the Swaps prior to the LBSF Petition Date. A handful of Swaps were terminated after the LBSF Petition Date.

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[9] Ch. 11 Case No. 08-13555, Adv. No. 10-03547 (Bankr. S.D.N.Y June 28, 2016).

[10] 422 B.R. 407 (Bankr. S.D.N.Y. 2010).

[11] 452 B.R. 31 (Bankr. S.D.N.Y. 2011).

The Priority of Payment Provisions

If an event of default occurred under the terms of the Notes, an enforcement notice could be delivered by the trustee accelerating the payments due and owing under the Notes, triggering an early termination of the Swaps and permitting the Collateral to be liquidated with any proceeds then required to be distributed in accordance with the applicable priority of payment provisions. It is the priority of payment provisions that were central to this decision.

The CDO transactions used two different priority of payment provisions:

(a) Under the first type, LBSF held a right to payment in priority ahead of the Noteholders that was fixed at the outset of the CDO transaction. However, if the conditions for an alternative priority were satisfied after this time, LBSF would lose its payment priority. CDO transactions with these provisions were referred to by the Court as "**Type 1 Transactions**". Of the CDO transactions considered, only five were Type 1 Transactions.

(b) Under the second type, the priority of payment was <u>not</u> fixed at the outset of the CDO transaction, but instead had two potential priorities that could become applicable. One of the options gave priority to LBSF whilst the other gave priority to the Noteholders. LBSF did not have a right to payment priority ahead of the Noteholders, only a right to be paid proceeds of the Collateral pursuant to one of the applicable provisions. Which priority applied would remain unknown until a default occurred and the circumstances surrounding it were determined. CDO transactions with these provisions were referred to by the Court as "**Type 2 Transactions**". The vast majority of the CDO transactions were Type 2 Transactions.

Importantly, both types of priority of payment provisions provided that, where an early termination of the Swaps occurred as a result of the bankruptcy of LBHI or LBSF, the Noteholders held payment priority ahead of LBSF. As a result of the bankruptcy filings of LBHI and LBSF, the priority of payment provisions giving the Noteholders priority ahead of LBSF were applied. The proceeds of the liquidation of the Collateral were insufficient to make any payments to LBSF.

Although the practical effect of the priority of payment provisions under the Type 1 Transactions and the Type 2 Transactions were the same, the differences in how these provisions were drafted (as set out above) was a material factor in the Court's decision.

Were the priority of payment provisions unenforceable *ipso facto* clauses?

<u>Anti-*ipso facto* provisions</u>

Under the US Bankruptcy Code, an *ipso facto* clause is a one that modifies the rights of a debtor due to the filing of a bankruptcy petition by a debtor. Such clauses are generally unenforceable pursuant to Sections 365(e), 541 and 363(1) of the US Bankruptcy Code (these provisions were collectively referred to in the Court's decision as the "***anti-ipso facto* provisions**"). For example, Section 365(e) relevantly provides as follows:

> *an executory contract … of the debtor may not be terminated or modified, and any right or obligation under such contract … may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract … that is conditioned on … the commencement of a case under this title … .*

Based on a review of the anti-*ipso facto* provisions, the Court stated that in order to determine whether the priority payment provisions constituted *ipso facto* clauses it would need to consider three factors:

(1) the nature of the rights held by LBSF prior to the relevant Swap early termination date;

(2) whether the enforcement of the priority of payment provisions modified any right of LBSF; and

(3) if there was a modification, when such modification occurred.

The Court analysed both the Type 1 Transactions and Type 2 Transactions against these three factors.

<u>Type 1 Transactions</u>

The Court concluded that, because LBSF held a right to payment of priority ahead of the Noteholders that was fixed from the outset of the Type 1 Transactions, the subsequent removal of that right because of LBSF's default due to its bankruptcy filing was, absent any safe harbour protection, unenforceable as an *ipso facto* clause.

<u>Type 2 Transactions</u>

The Court concluded that, because LBSF never held a right to payment of priority ahead of the Noteholders and instead only held a right to receive the Collateral pursuant to the then prevailing priority of payment, the subsequent application of the payment of priority that gave priority to the Noteholders ahead of LBSF did not modify an existing right. Therefore, the priority of payment provisions were not an *ipso facto* clause and were enforceable.

The Court noted that, even if it had decided differently that the rights of LBSF were modified, the fact that such modifications for the majority of the CDO transactions occurred <u>before</u> the LBSF Petition Date meant that the priority of payment provisions did not violate the anti-*ipso facto* provisions as these provisions only apply where a modification of rights occurs <u>after</u> a debtor's bankruptcy filing (which, in this case, was the LBSF Petition Date). Because, under each Type 1 Transaction, the termination of the related Swaps, the liquidation of the Collateral and the distribution of proceeds occurred <u>after</u> the LBSF Petition Date, the Court's alternative holding did not apply to the Type 1 Transactions.

The Court declined to adopt the so-called "**singular event**" theory set out by Judge Peck in BNY. Under this theory, the LBSF Petition Date and LBHI Petition Date would have been treated as a single event with the result that the relevant bankruptcy filing date for the purposes of the anti-*ipso facto* provisions would have instead been the earlier LBHI Petition Date (i.e., 15 September 2008, not 3 October 2008). The Court therefore confirmed that only LBSF's bankruptcy filing mattered for the analysis of the anti-*ipso facto* provisions and thus the LBSF Petition Date was the applicable date, and not the LBHI Petition Date as it was the rights of LBSF as counterparty to the Swaps that were at issue, not those of LBHI.

Was a US Bankruptcy Code safe harbour available?

After finding that the Type 2 Transactions did not violate the anti-ipso facto provisions, the Court turned to whether the Type 1 Transactions, which violated such provisions, were nonetheless subject to a US Bankruptcy Code safe harbour.

Section 560 of the US Bankruptcy Code provides that the exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination or acceleration of a swap agreement shall not be stayed, avoided or otherwise limited by any provision of the US Bankruptcy Code or any court order (the "**Swap Bankruptcy Safe Harbour**").

In declining to adopt the rulings of Judge Peck in BNY and Ballyrock, the Court noted that the safe harbours contained in the US Bankruptcy Code (including the Swap Bankruptcy Safe Harbour) are to be interpreted broadly and literally. In the Court's view, this was consistent with its prior decisions which emphasised that the various safe harbours are intended to protect the stability and efficiency of the financial markets.

In light of this, the Court made the following three findings:

(1) *First*, the use of the terms "**termination**" and "**liquidation**" therein should be interpreted to have two distinct meanings – the term "**termination**" covered the actual termination of the Swaps and the term "**liquidation**" was broad enough to cover the subsequent liquidation of the Collateral as well as the distribution of the proceeds pursuant to the priority of payments. It was not a relevant consideration that the priority of payments in effect gave the Noteholders priority ahead of LBSF.

(2) *Second*, because the priority of payment provisions were either explicitly part of the Swaps documentation or incorporated through schedules, they formed part of the Swaps and were therefore rights of "**swap participants**".

(3) *Third*, the enforcement of the priority of payment provisions was a right of the issuers, being counterparties to the Swaps and therefore "**swap counterparties**", that was protected by the Swap Bankruptcy Safe Harbour. The fact that the termination of the Swaps and the liquidation and distribution of the Collateral were rights that could be exercised by the issuer was sufficient for those rights to be protected, notwithstanding that it was the trustee, acting on behalf of the issuers, who actually exercised such rights.

The Court therefore concluded that enforcement of the priority of payment provisions satisfied the elements of the Swap Bankruptcy Safe Harbour and thus those provisions could not be stayed, avoided or otherwise limited by the US Bankruptcy Code (including by application of the anti-*ipso facto* provisions) or any court order. Therefore, even though the priority of payment provisions in the Type 1 Transactions were in theory unenforceable under the anti-*ipso facto* provisions, the distributions made pursuant to such provisions were nonetheless enforceable through by the Swap Bankruptcy Safe Harbour. The same conclusion would also apply to the Type 2 Transactions, although as the priority of payment provisions applicable to such transactions were enforceable (i.e., they were not caught by the anti-*ipso facto* provisions) the distributions were already protected.

Developments in Europe

Brexit – Implications for the Derivatives Market

Introduction

The UK referendum vote for the UK to exit the European Union ("**EU**") ("**Brexit"**) raises significant potential issues for the derivatives market.

Prior to the referendum held in the UK on 23 June 2016, the International Monetary Fund and the Bank of England had warned that Brexit could have a material impact on the UK economy. Certainly, the immediate result of the Brexit vote was a period of economic volatility, coupled with a significant devaluation of sterling.[12] In addition, the UK's sovereign rating post Brexit was downgraded by Standard & Poor's and Fitch.[13]

It is unclear when the UK will officially commence the "**departure process**" by invoking Article 50 of the Treaty of the EU which would activate the 2 years negotiation process between the UK and the EU.

We set out some initial observations on the immediate impact of Brexit on derivative transactions, particularly in relation to derivative transactions involving sterling, sterling collateral or UK counterparties.

Immediate Impact of Brexit

(a) **Counterparty Creditworthiness**

One possible impact of Brexit is that a derivative counterparties' creditworthiness may be adversely affected by Brexit. This could result in more expensive financing costs (for new or existing transactions) or new or additional collateral posting obligations. In an extreme scenario, termination rights could be triggered (if ratings related or if the counterparty becomes credit impaired).

(b) **Sovereign Downgrade**

If the UK's credit rating is downgraded, the creditworthiness of counterparties with UK exposures may be adversely affected, which could result in additional financing costs (for new or existing transactions) or new or additional collateral posting obligations. In an extreme scenario, termination rights could be triggered (if ratings related or if the counterparty becomes credit impaired).

(c) **Exposure Fluctuations**

Economic volatility may lead to new (or increased) mark to market exposures under derivative transactions resulting in new (or increased) collateral posting requirements. In an extreme scenario, termination rights could be triggered.

(d) **Collateral Valuation Fluctuations**

Economic volatility, rating downgrades or currency fluctuations could lead to increased collateral posting requirements (especially if the value of UK collateral declines or if exposures in other currencies increase relative to sterling).

(e) **Derivatives Documentation**

It is currently difficult to assess the full impact of Brexit on derivatives documentation as the precise impact can only be assessed once the form and/or content of the post-Brexit legal arrangements are known and in particular, the final status of the UK and its relationship with the EU. At this stage, there seems to be little utility in carrying out a detailed review of one's derivatives documentation to gauge the effect of Brexit and/or amending standard derivatives documentation to cater for Brexit; although there could be some benefit in conducting a due diligence exercise to identify non-standard events of

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12 See "Sterling falls below Friday's 31-year low amid Brexit uncertainty", CNBC, 27 June 2016.

13 See Reuters Business News, Monday 27 June 2016, "Rating agencies rip into UK's credit score after Brexit vote". See also "Moody's changes outlook on UK sovereign rating to negative from stable, affirms Aa1 rating" published on 24 June 2016 by Moody's Investors Service.

default and/or termination events which could be triggered by Brexit and/or some analysis as to which counterparties/contracts are likely to be the most affected by Brexit.

Impact on Derivatives Documentation

We set out below some initial observations on the effect of Brexit on derivatives documentation.

(a) **Standard ISDA Representations and Covenants**

We consider it unlikely that the standard 1992 ISDA Master Agreement (Multicurrency – Cross Border) (the "**1992 ISDA Master Agreement**") and/or the 2002 ISDA Master Agreement (the "**2002 ISDA Master Agreement**" and together with the 1992 Master Agreement, the "**ISDA Master Agreement**") in each case published by the International Swaps and Derivatives Associations, Inc. ("**ISDA**") representations and covenants would be adversely affected by Brexit. Specific references to EU/UK laws and regulations may need to be updated. Specific attention will need to be given to non-standard representations and covenants relating to creditworthiness, ratings and/or market conditions.

(b) **Standard ISDA Events of Default**

We consider it unlikely that the standard ISDA Master Agreement events of default would be adversely affected by Brexit. Specific references to EU/UK laws and regulations may need to be updated. Specific attention will need to be given to non-standard events of default relating to creditworthiness, ratings and/or market conditions.

(c) **Standard ISDA Termination Events**

We consider it unlikely that the standard ISDA Master Agreement termination events would be adversely affected by Brexit. Specific references to EU/UK laws and regulations may need to be updated. Specific attention will need to be given to non-standard termination events relating to creditworthiness, ratings and/or market conditions.

(d) **Illegality**

In addition to our comments under "*Standard ISDA Termination Events*" above, we consider it unlikely that Brexit will result in performance under a standard ISDA Master Agreement becoming illegal, impossible or impracticable (including force majeure). Specific references to EU/UK laws and regulations may need to be updated. Specific attention will need to be given to non-standard termination events relating to performance (including force majeure) and any withdrawal of passporting rights (which may adversely affect the legality of the performance of cross-border transactions).

(e) **Withholding Tax**

It is possible that tax events could be triggered if there is a change in the cross-border withholding tax regime post Brexit (although this seems quite unlikely).

(f) **Material Adverse Change**

We consider it unlikely that a MAC clause would be adversely affected by Brexit. Specific references to EU/UK laws and regulations may need to be updated. Specific attention will need to be given to those contracts in which a counterparty's business is dependent on EU legislation and/or free access to the UK/EU markets.

(g) **Choice of English Law**

It seems unlikely that Brexit will adversely affect the enforceability of derivative contracts governed by English law. This aspect is considered in more detail below under the heading "*Choice of English law*".

(h) **Choice of English Jurisdiction**

It seems unlikely that Brexit will adversely affect derivative contracts containing an express submission to the English courts as the chosen disputes resolution forum. This aspect is considered in more detail below under the heading "*Choice of English jurisdiction*". Special attention will need to be paid to jurisdiction clauses drafted by reference to EU laws and regulations, such as Section 13(b)(i)(1) of the 2002 ISDA Master Agreement. One would expect that some of the required amendments to market standard documentation to implement Brexit will be dealt with by way of industry protocols.

(i) **EU Laws and Regulations**

The derivatives market is cross border in nature and a multitude of UK and EU laws and regulations govern the derivatives market and its operation. Market infrastructure also relies on EU and local recognition agreements. There are a number of key EU directives and regulations that will need to be dealt with as part of the Brexit transition. Whilst there is the possibility that there may be a gap in applicable law (i.e. the existing law ceases to apply before new laws are introduced or there are omissions in the new law), we would expect the legal framework for the derivatives market to be substantially settled by the time Brexit occurs. The key areas to be aware of include:

(i) the continuation of the MiFID passport for cross border financial services;

(ii) the continuation of safeguards for collateral netting, set-off and financial collateral arrangements (as currently envisaged in the Financial Collateral Directive (2002/47/EC), the Bank Recovery and Resolution Directive (2014/59/EU) and the Credit Institutions Winding Up Directive (2001/24/EC));

(iii) the continuation of the cross-border recognition of EMIR (see further below under the heading "*Trade reporting, clearing and risk mitigation*"); and

(iv) the continuation of cross-border access to market infrastructure under the Markets in Financial Instruments Directive II (2014/65/EU), the Markets in Financial Instruments Regulation (Regulation (EU) No 600/2014) and the Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories ("**EMIR**").

(j) **Contractual Bail-in**

Under current law, derivative contracts governed by the law of a non-EEA[14] country relating to the liability of an in-scope entity must include a bail-in provision (the "**Article 55 requirement**").

It seems unlikely that the UK would repeal applicable legislation which transposes the Bank Recovery and Resolution Directive into UK law[15] and more likely that UK banks would still need to include bail-in provisions in their derivative contracts post Brexit to satisfy the Article 55 requirement. However, if the UK did not retain EEA membership post Brexit, EU banks would need to include bail-in provisions in their derivative contracts which are governed by English law. This would be a substantial documentation requirement unless dealt with by way of an industry protocol.

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[14] 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. Switzerland is not part of the EEA but has a bilateral agreement with the EU.

[15] See PRA policy statement (PS1/15, PS 15/2 and PS 17/16) and BoE/PRA Supervisory Statement 7/16, the Bank Recovery and Resolution (No 2) Order 2014, the Banking Act 2009 (Mandatory Compensation Arrangements Following Bail-In) Regulations 2014, the Banking Act 2009 (Restriction of Special Bail-in Provisions, etc) Order 2014, the Building Societies Order 2014, the Bank Recovery Bail-in and Resolution Order 2014 and the Banks and Building Societies (Depositor Preference and Priorities) Order 2014.

(k) **Trade Reporting, Clearing and Risk Mitigation**

Pursuant to EMIR, specified entities are subject to detailed rules concerning trade reporting, clearing and risk mitigation requirements. EMIR binds in its entirety[16] and is directly applicable in all EU Member States[17] since it was enacted in the form of an EU regulation.[18] EMIR would no directly apply to the UK post Brexit since the UK would become a "***third country entity***". The term "***third country entity***" is not defined in EMIR. However, in the context of the application of certain obligations, EMIR distinguishes between entities that are established in the EU (financial counterparties and non-financial counterparties) and entities that are not established in the EU.

The meaning of "***established***" has also not been defined in this context; existing commentary from European authorities suggests that it refers to the jurisdiction in which an entity is incorporated or otherwise constituted (rather than any physical presence from which it does business, to the extent that this differs from its jurisdiction of incorporation or constitution); for example, an entity which is incorporated outside the EU but has a physical presence in the EU by way of a branch would still be a "***third country entity***".

The European Commission (the "**Commission**") has the power under EMIR to declare that the supervisory arrangements relating to trade reporting, clearing and risk mitigation of a non-EU jurisdiction are "*equivalent*" to the EU legislative framework under EMIR so that if an equivalence decision is made, such applicable non-EU counterparties will be deemed to have satisfied their applicable EMIR obligations.

The UK will need to determine whether to negotiate to continue under EMIR in a similar way to Iceland, Liechtenstein and Norway (which are in the EEA but not in the EU) or to seek bilateral "equivalence" arrangements with other jurisdictions or the EU as a whole (pursuant to Article 13.2 of EMIR). Regardless of such negotiations, UK counterparties will need to comply with at least some of the existing EMIR obligations when trading with EU counterparties post Brexit. For example, EU branches of UK banks would need to comply with certain obligations under EMIR.

Similarly, UK branches of EU banks may need to comply with UK comparable laws in relation to trade reporting, clearing and risk mitigation. However, this will depend whether the UK wants to create a different regime from EMIR. With the enormous amount of legislation that will need to be reviewed, it is plausible to assume that the UK will try to maintain existing EMIR legislation which UK counterparties are already familiar with.

In the absence of an "equivalent" decision, UK counterparties may have to comply with UK enacted laws and EMIR (as amended from time to time) in relation to trade reporting, clearing and risk mitigation when contracting with EU counterparties. Conversely, EU counterparties may have to comply with UK enacted laws and EMIR (as amended from time to time) in relation to trade reporting, clearing and risk mitigation when contracting with UK counterparties.

Currently, the mandatory clearing obligation can only be satisfied if applicable derivative contracts are cleared through either an authorised (in the case of an EU CCP) or recognised (in the case of a non-EU CCP) central counterparty ("**CCP**"). Non-EU CCPs are recognised if the Commission has determined that the non-EU supervisory arrangements relating to such CCPs are "equivalent" to those under EMIR.

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16 However, please see Article 12 of EMIR which allows EU Member States to lay down rules on penalties.

17 The EU is an economic and political union of 28 countries. It operates an internal (or single) market which allows free movement of goods, capital, services and people between member states. The current EU Member States are: Austria, Belgium, Bulgaria, Croatia, Republic of Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden and the UK. As a result of Brexit, the UK will cease to be an EU Member State.

18 Article 288 of the Treaty of the Functioning of the European Union.

Similarly, the trade reporting requirement under EMIR can only be satisfied if the relevant derivative contracts are reported to an authorised trade repository ("**TR**") (in the case of an EU Trade Repository) or recognised TR (in the case of a non-EU TR). Non-EU TRs are recognised if pursuant to Article 77 of EMIR the Commission has determined that the non-EU legal and supervisory arrangements relating to such TRs are "*equivalent*' to those under EMIR.

One possible scenario is that UK based CCPs and UK based TRs may need to apply for recognition under EMIR pursuant to Article 25 or 77 (respectively) of EMIR in order to provide clearing and reporting services in the EU. Similarly, EU based CCPs and EU based TRs will need to apply for recognition in the UK in order to carry on their clearing and reporting services in the UK.

An open question is the extent to which the UK will be able to benefit from the existing EU negotiated arrangements with non-EU countries, i.e. whether the UK would still benefit from the current implementing acts with third countries (Australia, Canada, Hong Kong, Japan, the USA, etc.) In principle, those third countries with existing equivalence arrangements with the EU should have no issues replicating similar arrangements with the UK (which is fully EMIR compliant). Failing this, the UK may end up in the unenviable position of having to start from scratch equivalence negotiations with non-EU countries. However, it is difficult to predict the effect of exogenous factors (politics, lack of resourcing etc.) on the timing and outcome of recognition or equivalence decisions.

Further, if in a post-Brexit scenario, a UK based CCP no longer benefits from the authorisation or recognition (as the case may be) under EMIR, this could have adverse regulatory capital implications.

Particular issues could arise for UK clearing members of EU CCPs as such entities will cease to be EU credit institutions post Brexit and therefore may no longer be eligible to be a clearing member under the relevant EU CCP's eligibility criteria. The converse could apply to EU clearing members of UK CCPs.

The European Central Bank could also renew its attempt to have CCPs having more than 5% of Euro denominated products located in the EU. In March 2015, the EU General Court ruled that the European Central Bank did not have the "competence necessary to regulate the activity of security clearing systems" and such an attempt failed.

(l) **Choice of English Law**

English law is the most popular choice of law for cross-border transactions and many of the reasons why commercial parties choose English law will not change as a result of Brexit.

EU Member States currently apply the same rules to determine the governing law of contractual (as a result of the Rome 1 Regulation (Regulation (EC) No 593/2008)) and non-contractual (as a result of the Rome II Regulation (Regulation (EC) No 864/2007)) obligations. Such regulations generally require EU Member State courts to respect party autonomy of choice of law, subject to limited exceptions. Such requirements also apply regardless of whether the contracting parties are located in the EU and/or whether the chosen law is a law of an EU Member State.

If post Brexit the UK decided to leave the principles enshrined in the Rome 1 and Rome II Regulations in place, with the English courts (as opposed to the European Member State courts) as the arbiter of such Regulations, there will be little short term impact as a result of Brexit; although over time, the interpretations of such Regulations could diverge between the English courts and the courts of the EU Member States.

If the Rome 1 and Rome II Regulations were no longer to apply in the UK post Brexit, one would assume that the UK would revert to the law in force prior to the introduction of the Rome I and Rome II Regulations: namely, the Rome Convention[19] (in the case of contractual obligations) and the Private International Law (Miscellaneous Provisions) Act 1995 (in the case of non-contractual obligations). There is no significant difference between the provisions of the Rome Convention and the Rome 1 Regulation; in particular, in relation to party autonomy concerning choice of governing law. In relation

19 The Convention on the Law Applicable to Contractual Obligations 1980.

to non-contractual obligations, there are differences between the Rome II Regulation and the Private International Law (Miscellaneous Provisions) Act 1995; in particular, the Private International Law (Miscellaneous Provisions) Act 1995 does not give the parties an express right to choose the law applicable to non-contractual obligations. So far as the other EU Member States are concerned, the Rome 1 and Rome II Regulations will continue to apply to a choice of English law irrespective of whether the UK is an EU Member State or not.

Substantive English commercial law has developed largely independently of EU law (other than in specific areas such as consumer contracts, insurance and agency contracts). The English law on key contractual issues such as contractual interpretation, estoppel, the implication of terms, penalties and forfeiture derives principally from English common law and any effect of Brexit is likely to be practically limited.

A similar position applies in English torts law apart from statutory torts that have a European law basis. Specific areas will require detailed consideration such as financial services regulation, prospectus rules and consumer protection, but general English commercial law will remain largely unaffected by Brexit.

(m) **Choice of English Jurisdiction**

It is critical that commercial parties have the ability to choose which court will resolve commercial disputes. The implementation of rules applied by EU Member States in relation to jurisdiction and the enforcement of judgments (now set out in the Recast Brussels Regulation EU1215/2012 (the "**Recast Regulation**")) has been one of the successful EU initiatives, subject to the rules relating to parallel proceedings and so-called torpedo litigation (such a strategy is now largely ineffective in the case of an exclusive jurisdiction clause, although the position where only one party to a contract is bound to a chosen court is still unclear). Pursuant to the Recast Regulation, the EU Member State courts must recognize and enforce judgments of another EU Member State and party autonomy is respected, subject to limited exceptions.

There are other reasons why, notwithstanding the Recast Regulation, commercial parties choose to litigate their disputes in the English courts and such reasons are unlikely to be significantly affected by Brexit. In general, we would expect commercial parties to continue to select the English courts in their commercial contracts, subject to limited exceptions.

If the UK adopts the Norwegian model post Brexit,[20] one would expect the UK to accede to the 2007 Lugano Convention,[21] (which is broadly similar, but not identical, to the existing EU regime). If the UK adopts the WTO model post Brexit,[22] the UK could still negotiate to accede to the 2007 Lugano Convention and/or the Hague Convention on Choice of Court Agreements (the "**Hague Convention**") which provides a mechanism for the allocation of jurisdiction and the enforcement and recognition of judgments between contracting states where the parties have agreed an exclusive jurisdiction clause in relation to a contracting state.[23] Note that for entirely EU matters, the Recast Regulation prevails over the Hague Convention. It is a moot point as to whether the UK would need to resign the Hague Convention in its own right in order to ensure such convention is effective post Brexit in relation to the UK.

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20 See "*Five models for post-Brexit UK trade*", BBC News – EU Referendum, 27 June 2016.

21 Convention on jurisdiction and enforcement of judgments in civil and commercial matters signed in Lugano on 30 October 2007 which governs issues of jurisdiction and enforcement of judgments between the EU Member States and Iceland, Switzerland and Norway. Published in the Official Journal on 21 December 2007 (L339/3). Incorporated into UK Law by the Civil Jurisdiction and Judgments Regulations 2009.

22 See "*Five models for post-Brexit UK trade*", BBC News – EU Referendum, 27 June 2016.

23 In 2005, the Hague Conference on private international law finalized the text of the Hague Convention which became applicable in the EU Member States (other than Denmark) in October 2015. The Hague Convention is accompanied by an official explanatory report by Professors Hartley and Dogauchi (the "**Hague Convention Report**"). Copies of the Hague Convention, the Hague Convention Report and a status table are available at the Choice of Court section of the Hague Conference's website: http://www.hcch.net/index_en.php?act=text.display&tid=134.

Regardless of any agreement with EU Member States as to choice of jurisdiction, the English courts are likely to continue to recognise party autonomy. Although it is an open question as to how such clauses will be interpreted by the courts of the EU Member States, it seems likely that the EU Member State courts will continue to recognise party autonomy as to choice of jurisdiction. Note that the UK had previously been a party to a number of reciprocal enforcement arrangements with a number of EU Member States - see the Foreign Judgments (Reciprocal Enforcement) Act 1933. Note that the Recast Regulation allows EU Member State courts to decline jurisdiction in favour of non-EU Member State courts in limited circumstances (see Articles 33 and 34 of the Recast Regulation). It is also possible that the Brussels Convention ((Regulation (EC) 44/2001), the predecessor to the Recast Regulation) could apply.

(n) **Parallel Proceedings and Anti-suit Injunctions**

One can anticipate an increase in parallel proceedings and anti-suit injunctions post Brexit. Under the current EU regime, if parallel proceedings are bought in more than one court of a EU Member State, the court first seized decides the question of jurisdiction unless the parties have conferred exclusive jurisdiction on the courts of another EU Member State in which case the chosen court can determine the question of jurisdiction (notwithstanding that such chosen court was not first seized). Such a provision dramatically reduces the risk of parallel proceedings in the EU Member States (although the position in relation to asymmetric exclusive jurisdiction clauses is still unclear). It is noteworthy that such a provision does not exist in the 2007 Lugano Convention. Further, if the courts of an EU Member State do not respect an English jurisdiction clause; post Brexit the English courts may be inclined to grant an anti-suit injunction against any party which commenced proceedings in an EU Member State court in breach of an English jurisdiction clause to restrain the continuation of such proceedings. Anti-suit injunctions could also be revived in the arbitration context (i.e. to protect UK arbitration).

(o) **Arbitration**

There could also be a shift to arbitration (given the enforcement mechanisms for arbitral awards set out in the New York Convention) as the chosen dispute resolution forum (as many countries are a party to the New York Convention).[24]

(p) **Service of Process**

Service of process out of England could become more complex post Brexit, although current market practice typically requires an agent for service of process to be appointed for non-UK counterparties. If an agent for service of process is appointed in the UK, service of process pre Brexit and post Brexit will be straightforward. If service of process needs to be effected overseas, the claimant needed to apply to the English courts for permission to serve out of the jurisdiction. This in turn required the claimant to demonstrate that the English courts had jurisdiction. In the case of service in the EU, there was no need to apply for permission to serve out of the UK if the English courts had jurisdiction pursuant to the Recast Regulation. Further, the Service Regulation (1393/2007/EC) provides helpful assistance with the procedural aspects of effecting service. A similar position applies in relation to service in countries which are a party to the 2007 Lugano Convention. If an agent for service of process in the UK is not appointed post Brexit, it could be necessary to apply to the English courts for permission to serve out of the UK jurisdiction into an EU Member State.

(q) **Pre-existing Agreements**

There will likely to be an increase in disputes relating to existing derivatives documentation post Brexit. In addition to the matters flagged above concerning "*Standard ISDA Events of Default*" and "*Standard ISDA Termination Events*", contracting parties could seek to exit unprofitable contracts or renegotiate contractual terms. This could arise as a result of contractual uncertainty related to questions of contractual construction and contractual interpretation; for example (and by no means an exhaustive list), how will obligations to comply with specific provisions of EU law be interpreted post

[24] The New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, concluded in 1958. Such Convention provides a regime for the enforcement and recognition of arbitral awards within contracting states.

Brexit; will the UK be included in the "European Union" or not; what law applies where EU law applied at the time of entering into a contract, but not at the time of its performance; and, to what extent should principles of EU case law established prior to Brexit influence the English courts interpretation of similar UK legislation enacted as a result of Brexit.

How does Brexit currently affect you?

At this stage, there is no market consensus as to what steps to recommend to market participants to deal with Brexit. There is currently too much uncertainty to perform a meaningful assessment of the effect of Brexit on derivatives documentation and derivatives transactions. Market participants will need to monitor Brexit developments closely over the transition period. We will continue to publish Brexit related topics of interest once further details of the form, content and timing of Brexit are revealed.

Bail-in – Valuation of Derivative Contracts

Introduction

A Commission Delegated Resolution (EU) 2016/1401 ("**CDRVD**") on the valuation of derivatives for the purpose of bail-in pursuant to Article 49(4) of the Bank Recovery and Resolution Directive 2014/59/EU (the "**BRRD**") was published in the Official Journal of the European Union on 23 August 2016. The CDRVD enters into force on 12 September 2016. The CDRVD is substantially similar to the regulatory technical standard adopted by the European Commission (the "**Commission**") on 23 May 2016.

The BRRD bail-in requirement applies to EU incorporated banks and large investment firms and their EU incorporated holding companies and their EU subsidiaries (including non-EU branches of EU incorporated firms). The BRRD bail-in requirement does not apply to non-EU incorporated firms or their EU branches.

Background

Pursuant to Article 63(1)(e) and (f) of the BRRD, a national resolution authority ("**RA**") may write down or convert into equity "eligible liabilities" of an institution in resolution ("**IIR**"). Liabilities arising under derivative contracts ("**DCs**") if: (i) not excluded by: (a) the provisions of Article 44(2) of the BRRD;[25] or (b) the RA under Article 44(3) of the BRRD in exceptional circumstances (see further below); or (ii) unsecured or uncollateralised (but only to the extent such DCs are unsecured or uncollateralised) are "eligible liabilities" potentially subject to a bail-in (such derivative liabilities are referred to herein as "**PBIDLs**"). Whilst any write down or conversion of PBIDLs applies only on close-out of the relevant DCs, Article 63(1)(k) of the BRRD gives the RA the ability to terminate and close out any DCs (whether collateralised or not) for the purposes of bail-in.

It is noteworthy that the universe of PBIDLs potentially subject to bail-in should decline due to:

(a) the implementation of mandatory clearing requirements (resulting in mandated margin requirements) pursuant to EMIR;[26] and/or

(b) the implementation of collateralisation requirements applicable to uncleared derivatives pursuant to EMIR; and

(c) existing margin rules imposed by central counterparties ("**CCPs**") relating to existing cleared transactions (collectively, "**Collateralised PBIDLs**").

Collateralised PBIDLs are only subject to bail-in to the extent of a net balance being due (i.e. the value of the DC liability is greater than the value of the collateral/security/margin). However, in normal market conditions, in the case of cleared transactions, it is not expected that the default of a clearing member would result in losses in excess of posted collateral/margin.

<u>Exceptional circumstances</u>

On a case by case basis, a RA may exclude PBIDLs from bail-in in exceptional circumstances. As set out in Article 44(3) of the BRRD, such exceptional circumstances include: (a) where the bail-in of PBIDLs would cause such a value destruction that the losses borne by other creditors would be higher than if those PBIDLs were excluded from bail-in; and (b) where it is not possible to conduct a bail-in within a reasonable time. Pursuant to Article 44(11) of the BRRD, the Commission adopted a delegated act in February 2016 specifying the circumstances in which PBIDLs could be excluded from bail-in. See Commission Delegated Regulation (EU) 2016/860 which provides (in Recital 5 thereto) that the ability to exclude PBIDLs from the operation of the bail-in tool should be used to the minimum extent necessary.

Close-out and Netting

The BRRD lays down the parameters for valuing PBIDLs as the first step in the bail-in process. Article 49(2) of the BRRD provides that the bail-in tools only apply after the PBIDLs have been closed out. As such, RAs have the power to terminate and close out PBIDLs (that are not otherwise excluded). Further, Article 49(3) of the BRRD requires that, where PBIDLs are subject to a netting agreement, the PBIDLs are to be determined on a

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25 There are general exclusions from the scope of bail-in under Article 44(2) of the BRRD (including but not limited to secured liabilities (to the extent that the value of the liability does not exceed the value of the collateral), client money, covered deposits and liabilities of less than 7 days owing to payment and settlement systems).

26 European Market Infrastructure Regulation (EU) No. 648/2012.

net basis in accordance with the provisions of the netting agreement.

Determination of Close-out Amounts

As a starting point, the RA is required to notify the counterparty ("**IIRCP**") of the termination and close-out of the DCs at the date and time specified in the notice, but which may also be immediate.[27] The IIRCP has a set period as set out in the notice to provide evidence of "commercially reasonable replacement trades".[28] The notice may also specify criteria by which the RA will assess whether any replacement trades are commercially reasonable.[29] This set period may be changed by the RA by notice to the IIRCP.[30]

If the IIRCP is able to provide evidence of "commercially reasonable replacement trades", the valuer (being an independent person appointed in accordance with Article 36 of the BRRD or, if this is not possible, the RA) is required to determine the close-out amounts at the prices of those replacement trades.[31] A "commercially reasonable replacement trade" is defined in the CDRVD to mean a "replacement trade entered into on a netted risk exposure basis, on terms consistent with common market practice and by making reasonable efforts to obtain best value for money".[32]

If the IIRCP fails to provide evidence of such replacement trades within the set period or the valuer considers the replacement trades to be on non-commercially reasonable terms, the RA may determine such valuation using:[33]

(a) mid-market end-of-day prices in line with the usual business practices of the IIR at the point in time of valuation;

(b) the mid-to-bid or mid-to-offer spread, depending on the direction of the netted risk position; and

(c) adjustments to these prices and spreads where necessary to reflect market liquidity (for the DCs in question), exposure size relative to market depth and model risk.

For the purposes of determining the close-out amount, the valuer is required to consider "a full range of available and reliable data sources" and may rely on "observable market data", "internal models", "independent price verification" (pursuant to the Capital Requirements Regulation),[34] "quotes from market-makers" and "data provided by counterparties".[35] If the DC is centrally cleared, values or estimates from CCPs can be used.[36]

Article 5(1) of the CDRVD requires the close-out amount to reflect the cost the IRRCP would incur to replace the economic equivalent of the terminated DCs "including the option rights of the parties in respect of those contracts".

The early termination amount determined by the valuer is the sum of the calculated close-out amount for all transactions in the netting set, plus any unpaid amounts, collateral or other amounts due from the IIR to its IIRCP, less any such amounts due to the IIR from the IIRCP.[37]

Article 4 of the CDRVD provides that the valuer must determine a single amount payable by the IIR or by the IIRCP as a result of the close-out of all DCs in a netting set thus protecting netting arrangements on a bail-in of DCs. A netting set is defined as "a group of contracts subject to a netting arrangement as defined in Article 2(1)(98) of Directive 2014/59/EU."[38]

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27 Article 3(1) and (3) of CDRVD.

28 Article 3(3) of the CDRVD.

29 Article 3(5) of the CDRVD.

30 Article 3(4) of the CDRVD.

31 Article 6(1) of the CDRVD.

32 Article 1(6) and (7) of the CDRVD.

33 Article 6(2) of the CDRVD

34 Regulation (EU) 575/2013.

35 Article 6(4) of the CDRVD.

36 Article 6(4)(a) of the CDRVD.

37 Article 5(1) of the CDRVD.

38 Article 1(1) of the CDRVD.

Article 49 of the BRRD requires the European Banking Association (the "**EBA**") to set out methodologies for comparing the value destruction caused by closing out DCs with the amount of losses that would be absorbed by those PBIDLs on bail-in. This methodology is set out in Article 2 of the CDRVD. Essentially, the RA is required to determine as a result of close-out:[39]

(a) the proportion of PBIDLs not exempt from bail-in and valued as part of the Article 36 valuation, within all "equally-ranked" liabilities multiplied by the total losses expected to be borne by all equal ranked liabilities (including the PBIDLs);[40] and

(b) the expected value destruction as the sum of the following items:[41]

    (i) the risk of increased claims from IIRCPs to reflect re-hedging costs;[42]

    (ii) the expected cost to the IIR of establishing hedges for open exposures to maintain an acceptable risk profile in accordance with the resolution strategy (such cost to be estimated by considering initial margin requirements and prevailing bid-offer spreads);[43]

    (iii) valuation impairments to underlying assets linked to the DCs being closed-out, impact on funding costs, income levels or other reductions to franchise value;[44] and

    (iv) any precautionary buffer against adverse effects of close-out such as cost of errors or disputes.[45]

Once these amounts are determined, they are to be compared prior to any decision being taken to close out the DCs.[46] If the expected losses from the close-out exceed the share of PBIDLs available for bail-in, the RA can exempt the PBIDLs from bail-in under Article 44(3) of the BRRD.

Cleared Derivatives

The general valuation method described above does not apply to centrally-cleared derivatives in circumstances where the IIR is a clearing member facing a CCP.[47]

CCPs are required under EMIR to have in place procedures for the default of a clearing member. Such procedures will typically include (as a first step) the CCP porting the IIR's cleared trades to another clearing member and, failing that, an auction of the IIR's trades amongst the other clearing members, the use of any collateral posted by the IIR and the use of default fund contributions. As any collateral posted by the IIR in accordance with the CCP's rules should be sufficient to cover the IIR's liability to the CCP, any bail-in right in respect of uncollateralised liabilities is unlikely to occur. In the case of a DC between the IIR and a CCP, the CDRVD uses the CCP's procedures for close-out of cleared derivatives to determine the relevant value.[48] The RA is required to notify the CCP and the CCP's competent authority of the decision to close out the DC and to agree with them a deadline by which the CCP must provide the valuation of the early termination amount.[49] The deadline may be changed by the RA.[50] If the CCP fails to provide a valuation by the deadline, or the valuation by the CCP is not in line with the CCP's default procedures, the RA may determine that the valuation methods described in the CDRVD for the valuation of non-cleared derivatives will apply.[51] Such a valuation may be made on a provisional basis, and an ex-post adjustment can be made.[52]

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39 Article 2(1) of the CDRVD.

40 Article 2(1)(a) of the CDRVD.

41 Article 2(1)(b) of the CDRVD.

42 Article 2(1)(b)(i) of the CDRVD.

43 Article 2(1)(b)(ii) of the CDRVD.

44 Article 2(1)(b)(iii) of the CDRVD.

45 Article 2(1)(b)iv) of the CDRVD.

46 Article 2(2) of the CDRVD.

47 Articles 3(6) and 6(6) of the CDRVD (except in the limited circumstances specified in Article 7(7) of the CDRVD).

48 Article 7(1) of the CDRVD.

49 Article 7(2) of the CDRVD.

50 Article 7(6) of the CDRVD.

51 Article 6(6) of the CDRVD.

52 Article 6(5) and 8(3) of the CDRVD.

Valuations of DCs which are not based on the CCP's default procedure are only for resolution purposes and do not otherwise not affect the CCP's contractual and rulebook obligations.

Timing of Close-out and Valuation

The valuer must determine the value of PBIDLs at the following point in time:[53]

(a) where the valuer determines the close-out amount (i) on the basis of commercially reasonable replacement trades provided by the IIRCP, at the date and time of such replacement trades;[54] or (ii) in accordance with CCP default procedures, at the date and time the early termination amount is determined by the CCP;[55] and

(b) in all other cases, the close-out date, or where that would not be commercially reasonable, the date and time at which a market price is available for the underlying asset.[56]

Where a provisional valuation is made, the determination of the close-out value can be made earlier than the points in time specified above, based on the observable market data available at the time.[57] The RA can request the valuer to update a provisional valuation at any time to reflect market developments or replacement trades, and where this evidence is available by the time close-out takes effect, it will be included in the definitive valuation under Article 36 of the BRRD.[58] The RA may then either adjust the treatment of creditors on bail-in, or provide compensation on the basis of the BRRD Article 74 valuation.

Similarly, if the valuer makes an early determination in respect of DCs entered between an IIR (which is a clearing member) and a CCP, the valuer must take account of estimates of expected losses provided by the CCP.[59] Such estimates must be updated if definitive termination values are provided by the CCP prior to the agreed deadline.[60]

Points to Note

Netting set: the protection provided by Article 4 of the CDRVD to "netting sets" does not apply to netting in the case of other non-DCs (such as repurchase and stock lending transactions) which also rely on close-out netting under master agreements. Although such non-DCs are typically collateralised (and therefore not eligible for bail-in to the extent secured or collateralised), such non-DCs would otherwise be eligible for bail-in to the extent there is or would be a net amount payable by the IRR, after taking account of any collateral or security. Counterparties to such non-DCs will need to rely on the no creditor worse off ("**NCWO**") principle to ensure that such non-DC liabilities are treated on a net basis for bail-in purposes.[61]

Cross product netting: as mentioned above, the protection provided by Article 4 of the CDRVD to "netting sets" does not apply to netting in the case of other non-DCs. Further, Article 4 of the CDRVD does not take into account cross-product netting agreements involving non-DC products. Counterparties to such non-DCs the subject of cross-product netting agreements will need to rely on the NCWO principle to ensure that such non-DC liabilities are treated on a net basis for bail-in purposes. This means that the IIRCP could experience a different result to that expected on a normal insolvency (where bail-in does not apply). It is also unclear how the NCWO principle would apply in this situation.

Valuations: the relationship between the BRRD Article 36 valuation, the BRRD Article 74 valuation and the valuation of DCs for write-down and conversion purposes set out in Article 49 of the BRRD is unclear. However, the CDRVD clarifies that the BRRD Article 49 valuation is to be treated as part of the BRRD Article 36 valuation with the aim of determining a prompt valuation for bail-in purposes.[62]

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53 Article 8(1) of the CDRVD.

54 Article 8(1)(a) of the CDRVD.

55 Article 8(1)(b) of the CDRVD.

56 Article 8(1)(c) of the CDRVD.

57 Article 8(2) of the CDRVD.

58 Article 8(3) of the CDRVD.

59 Article 8(4) of the CDRVD.

60 Article 8(4) of the CDRVD.

61 See Articles 36 and 74 of the BRRD.

62 See also Recital (22) of the CDRVD.

Valuation of replacement trades: pursuant to the CDRVD, if the IIRCP is able to provide evidence of commercially reasonable replacement trades, the valuer must determine the close-out amounts using those prices.[63] This methodology seems similar to the Market Quotation valuation measure under the 1992 ISDA Master Agreement in that it is based on market prices, except that the CDRVD uses executed trades, not just quotations, and there is no express requirement to use reference market-makers. The valuation simply has to be "commercially reasonable.[64] Whilst the valuer is entitled to specify the criteria which will apply in determining whether replacement trades are "commercially reasonable", there is no clear guidance as to what evidence is suitable for this purpose or as to the contents of any summary.[65]

Commercially reasonable replacement trades: it is unclear how the requirement to use a "commercially reasonable replacement trade" works under the CDRVD for bespoke transactions (if no common market practice exists) or how the requirement to make "reasonable efforts to obtain best value for money" should be interpreted (balancing factors such as speed and certainty of execution against price). Will the IIRCP have to consider alternative methods of execution (such as replacing transactions on a portfolio basis rather than individually)? Does the obligation to "mak[e] reasonable efforts in order to obtain best value for money" impose on the IIRCP a new (or higher) legal standard than that applicable under the DC in question? By way of comparison, the 2002 ISDA Master Agreement requires the use of "commercially reasonable procedures in order to produce a commercially reasonable result".

Fallback valuation: the use of the specified valuation inputs in the fallback valuation methodology set out in Article 6(2) of the CDRVD means that such valuation method is more similar to the calculation of a "Close-out Amount" under the 2002 ISDA Master Agreement than to the "Market Quotation" mechanism under the 1992 ISDA Master Agreement. However, costs of funding are not expressly included. If the IIRCP is not able to provide commercially reasonable replacement trades within the set period, the valuer is permitted to take into account a wide range of valuation data. Where a fallback valuation is to be performed, the IIRCP will only have limited control over the valuation method and process. Note that in order to provide certainty to the RA in relation to the BRRD Article 74 valuation, the BRRD does not provide for any automatic right of appeal for a creditor. However, as the NCWO principle is fundamental to the BRRD, Article 74 of the BRRD provides for a second independent valuation to be performed as soon as possible after the bail-in occurred.

Payments to maturity: the RA is required to take into account the close-out methodology set out in the relevant netting agreement. There is an obvious tension between such a requirement and the fallback valuation methodology set out in Article 6 of the CDRVD. Further, the close-out methodology in the relevant netting agreement will vary (under current English law) depending on whether the parties have contracted on the basis of the 1992 ISDA Master Agreement and the 2002 ISDA Master Agreement. Valuations under the 1992 ISDA Master Agreement and/or the 2002 ISDA Master Agreement may be different (and potentially significantly different) from valuations under the CDRVD and/or the BRRD. It is also unclear how this fits with the NCWO principle.

Clean versus dirty valuations: under current English law, there is a divergence of judicial opinion as to where one values clean i.e. assuming all payment obligations are performed to transaction maturity (in relation to the 1992 ISDA Master Agreement) or dirty i.e. taking into account provisions that may result in transaction termination prior to maturity (in relation to the 2002 ISDA Master Agreement). Article 5(1) of the CDRVD expressly requires that the close-out amount reflects the costs that the IIRCP would incur to replace the economic equivalent of the terminated DCs including "the option rights of the parties in respect of those contracts". This suggests that valuations will be "dirty" (as per the 2002 ISDA Master Agreement). Accordingly, if the DC in question is a 1992 ISDA Master Agreement, there could be a difference (and potentially a significant difference) between the expected close-out amount under the 1992 ISDA Master Agreement and the close-out amount calculated for the purpose of Article 49 of the BRRD. It is also unclear how this fits with the NCWO principle.

IIRCP creditworthiness: a IIRCP's creditworthiness may be taken into account in the 2002 ISDA Master Agreement. No equivalent provision is included in the CDRVD. If actual commercially reasonable replacement trade prices are obtained, this difference is of no consequence. However, if the fallback valuation methodology applies, there is no provision to adjust theoretical prices for counterparty credit. This creates a potential discrepancy between the 2002 ISDA close-out amount valuation and the BRRD Article 49 valuation. It is also unclear how this fits with the NCWO principle.

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[63] Article 6(1) of the CDRVD.

[64] See the definition of "replacement trade" in Article 1(6) of the CDRVD.

[65] See Article 3(3) of the CDRVD.

Unpaid amounts: unpaid amounts are taken into account in the termination amount.[66] The only guidance in the CDRVD as to how unpaid amounts are valued is the reference to "fair market value" where the unpaid amount represents the value of an undelivered asset where settlement is to be by delivery.[67]

Collateral: collateral is included in the determination of the termination amount if "due". The use of such a term is unfortunate as collateral may not be not technically due under the terms of the relevant DC.[68]

Equally ranked liabilities: for the purposes of determining the expected losses (as part of the numerator of the Article 36 valuation), Article 3(1)(a)(i) of the CDRVD requires that the portion of PBIDLs within all "equally-ranked" liabilities be determined. It is slightly unclear as to what are "equally ranked" liabilities for such purpose. Presumably, as a result of the application of Article 48 of the BRRD, equally ranked liabilities are all unsecured liabilities which are not Tier 2 or additional Tier 1 capital instruments or subordinated debt.

Cleared derivatives: the CDRVD specifies the valuation methodology (in the case of cleared derivatives) in the case of the DC between the clearing member (IIR) and the CCP. In simple terms, the valuation methodology used by the CCP will apply, other than in limited circumstances.[69] The CDRVD does not mandate a specified valuation methodology in relation to the DC between the clearing member and the end client. In the case of the end client DC, the general valuation methodology of the CDRVD will apply. This raises the possibility that the valuation of the end client CD and the clearing house DC could be different (and potentially significantly different). The end client's protection in this case, other than the NCWO principle, is to port the defaulted transaction (in accordance with the relevant CCP's rules) to a back-up clearing member.

Timing of valuation: Article 8(1) of the CDRVD specifies the time at which the valuer must determine the value of the PBIDLs. Further provisional valuations are permitted which may then be updated in the definitive valuation under Article 36. The RA may also adjust the treatment of creditors on bail-in, or provide compensation on the basis of the BRRD Article 74 valuation. This raises the possibility of timing differences between valuations under the CDRVD and/or the BRRD and under the relevant DC. Any difference in timing may result in a difference (and potentially a significant difference) between the expected valuation under the DC and the valuation determined for the purposes of bail-in. The CDRVD also mandates the use of end of day prices in certain instances (see Article 6(2)(a) and 6(5) of the CDRVD) and the use of mid-market prices in certain instances (see Article 6(2)(a) and 6(2)(b) of the CDRVD). There are no equivalent provisions in the 1992 ISDA Master Agreement and/or the 2002 ISDA Master Agreement.[70]

Comment

As mentioned above, the application of the bail-in tool to DCs will have no impact on Collateralised PBIDLs (to the extent that the value of the PBIDLs does not exceed the value of the related security/collateral/margin). Further, as PBIDLs may be complex and difficult to value, it may be the case that RAs are less inclined to bail-in PBIDLs (to avoid valuation disputes, the risk of litigation and breaching the NCWO principle) or more inclined to exempt PBIDLs from bail-in under Article 44(3) of the BRRD (subject to the exceptional circumstances limitation).

However, in relation to in-scope DCs, the valuation methodology under the CDRVD (subject to the NCWO principle) raises several valuation issues for IIRCPs; particularly for non-standard DCs or in abnormal market conditions where "commercially reasonable replacement trades" cannot be obtained.

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[66] Article 5(1) of the CDRVD.

[67] Article 5(2)(b) of the CDRVD.

[68] Article 5(1)(a) of the CDRVD.

[69] Article 3(6), 6(6) and 7(7) of the CDRVD.

[70] In the 2002 ISDA Master Agreement, mid-market valuations are used in the case of a termination due to Illegality or a Force Majeure Event.

Ruling of German Federal Court on Netting Rules under the German DRV file no. IX ZR 314/14

Introduction

A recent decision of Germany's highest court in civil matters, the German Federal Court of Justice (*Bundesgerichtshof*, the "**BGH**"), dated 9 June 2016 is likely to have a significant impact on netting clauses in a financial contract that is subject to German law. The BGH has determined that contractual provisions on netting arrangements that deviate from the statutory provision will be replaced by section 104 of the German Insolvency Code (*Insolvenzordnung*, the "**InsO**"). In response to the decision, a joint statement by the German Federal Ministry of Finance and the German Federal Ministry of Justice and Consumer Protection was issued stating that both ministries will initiate a statutory clarification at short notice to ensure that the usual master agreements continue to be accepted. Germany's regulatory authority, the German Federal Financial Supervisory Authority, (*Bundesanstalt für Finanzaufsicht* , the "**BaFin**") has also published an administrative decree, which provides that netting agreements pursuant to Article 295 of Regulation (EU) No. 575/2013 ("**CRR**") will be treated as effective from 10 June 2016 until 31 December 2016.

Key Findings

(a) The calculation method to determine a close-out amount and the calculation date must not deviate from the method / timeframe set out in section 104 paragraphs 2 and 3 of the InsO.

(b) Section 340 paragraph 2 of the InsO, a special conflict of law provision in the InsO, refers to the relevant applicable substantive insolvency law.

Background Facts

Two German companies, the plaintiffs in the BGH proceedings, had agreed under the German law master agreement (the "**DRV**") to grant the defendant, a trading company organised under the laws of England and Wales, stock options for shares in SAP AG. The stock options were secured by a pledge over SAP shares in favour of the defendant. The defendant became insolvent and administration proceedings were instituted in the UK, while the plaintiffs still had one option transaction open. The defendant demanded a compensation claim calculated on the basis of the close-out provision of the DRV in its favour, as the market value of the SAP shares of 15 September 2008 (the time of the close-out) was higher than the agreed option price. The plaintiffs refused to release the shares pledged to it.

The plaintiffs successfully challenged the defendant in the Regional Court of Frankfurt (18 O 374/10), but, except for a very small part, the Higher Regional Court of Frankfurt (the "**OLG**") as a competent court of appeal, awarded the defendant with a compensation claim calculated pursuant to the DRV (16 U 183/12). The BGH generally agrees with the OLG decision, thus accepting the defendant's claim, but disagrees with the calculation method under the DRV. The BGH stated that the calculation of the compensation claim should not be based on the DRV but on section 104 paragraphs 2 and 3 of the InsO, referring to the option's market price of 17 September 2008.

Reasoning

The decision is based on section 119 of the InsO, which states that "agreements excluding or limiting the application of sections 103 through 118 shall be invalid". As the DRV calculation method for the compensation claims in a netting agreement deviate from those laid out under section 104 paragraphs 2 and 3 of the InsO, the BGH came to the conclusion, that the derogating DRV provisions are invalid and the calculation method under section 104 paragraphs 2 and 3 of the InsO have to be applied. Furthermore the BGH explicitly ruled that, even though section 104 paragraph 2 sentence 3 of the InsO refers to master agreements, a deviation from section 104 of the InsO in contractual provisions is not applicable.

This new ruling is a consequent continuance of the previous BGH ruling of 15 November 2012 (BGHZ 195, 348 et seqq.). In this case the BGH also stated that section 119 of the InsO protects the foregoing provisions, here section 103.

In this context section 119 of the InsO has to be understood as a protection of the "cherry picking" right of the insolvency administrator, meaning that he has the right whether or not to enforce contracts which have not been fully performed yet or to terminate them.

Conclusion

The new BGH ruling affects all master agreements governed by German law, which include calculation methods that deviate from the provisions laid out in section 104 of the InsO. The consequence of the statutory netting is laid out in section 104 paragraph 3 of the InsO. Claims for performance are replaced by claims for non-performance covering the difference between the agreed price and the market or exchange price on a contractually agreed date (but at the latest on the fifth working day after the opening of insolvency proceedings; only without such agreement on the second working day), while the DRV replaced the relevant claims by compensation claims. Therefore there are two possible scenarios in which the contractual provision can become invalid: (1) the contractual provision uses a calculation method that deviates from the statutory provision, (2) the calculation date of the relevant values deviates from the timeframe provided for in section 104 paragraph 3 of the InsO.

However it is noticeable that a contractually agreed early termination of a transaction covered by section 104 of the InsO based on the filing for the opening of insolvency proceedings seems to be valid. The BGH has not ruled on this specific matter but as such early termination does not modify the provisions laid out in section 104 of the InsO, one might argue that such an early termination right may still be effective.

Furthermore this impact on netting agreements cannot be bypassed by choosing another governing contract law. Section 340 paragraph 2 of the InsO contains a special insolvency conflict of laws rule that specifies netting agreements shall be governed by the "laws of the country governing the agreement". But this provision is part of the conflict of insolvency laws section, meaning it only applies if the insolvency proceedings are subject to this section (sections 335 et seqq. of the InsO). This particular section of the InsO is subsidiary to the EU rules on international insolvency proceedings Council Regulation (EC) No.1346/2000 of 29 May 2000 on insolvency proceedings ("**EUIR**"). However insolvency proceedings concerning insurance companies, credit institutions, investment firms which provide services involving the holding of funds or securities for third parties, and collective investment undertakings (UCITS) are not within the scope of the EUIR.

While previously discussed whether "laws of the country governing the agreement" means the substantive insolvency law, the substantive contract law or the terms of the agreement, the new BGH ruling made clear, that section 340 (2) of the InsO refers to the relevant applicable substantive insolvency law.

Reaction by German Authorities and Politics

As this new BGH judgement caused some turmoil and uncertainties in the market, BaFin published an administrative decree on 9 June 2016, the day the BGH judgement was released. In it BaFin states that netting agreements as described in article 295 of the CRR are to be settled as agreed by their contractual parties, including those *ex officio* acting for or against them. As this decree entered into force on 10 June 2016 and will remain in effect until 12pm on 31 December 2016, this decree does not affect insolvency proceedings commenced before 9 June 2016.

This decree is intended to give the parliament enough time to amend the relevant InsO provisions and issue a new version, which , it is hoped, will reflect a more commercially acceptable interpretation.

Therefore the German Federal Ministry of Finance and the German Federal Ministry of Justice have published a joint statement, declaring that both ministries are willing to initiate immediate legislative measures to clear up the wording of the affected provisions.

The EMIR Clearing Obligation Update – Where Are We?

Background

Article 4(1)(b) of Regulation (EU) 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories ("**EMIR**") requires certain counterparties to clear OTC derivative contracts (pertaining to a class of OTC derivatives that has been declared subject to the clearing obligation) that are entered into or novated either on or after the date from which the clearing obligation takes effect or during the frontloading period. Under EMIR, the following entities may be subject to obligations:

Financial counterparty ("**FC**")	An entity established in the European Union ("**EU**") that falls in one of the following categories: • investment firms; • credit institutions; • insurance/reinsurance undertakings; • Undertakings for Collective Investment in Transferable Securities (UCITs) (i.e., mutual funds based in the EU) and their management companies; • certain pension schemes; and • alternative investment funds managed by alternative investment fund managers; in each case authorised or registered in accordance with the relevant EU Directive.
Non financial counterparty ("**NFC**")	An entity established in the EU that does not fall into any of the above categories for FCs. An NFC is not subject to the clearing obligation unless the gross notional value of all OTC derivative contracts entered into by the NFC and other NFCs (and third country equivalents) in its "*group*", **excluding eligible hedging transactions**, exceeds the relevant threshold below (in this case, the entity is referred to as an "**NFC+**").
Third country entity	All undertakings other than FCs and NFCs

The relevant thresholds to establish whether an NFC is an NFC+ are as follows:

EUR 1 billion for equity or credit derivatives; or

EUR 3 billion for interest rate, foreign exchange or commodities derivatives

Under EMIR the clearing obligation[71] applies to OTC derivative contracts concluded between:

Type of counterparty 1	Type of counterparty 2
FC	FC
FC	NFC+
NFC+	NFC+
FC or NFC+	Third country entity that would be subject to the clearing obligation if it was established in the EU.
Third country entity that "**would be subject to the clearing obligation if it was established in the EU**" *provided* the contract has a "**direct, substantial and foreseeable effect within the EU**" or where such an obligation is necessary or appropriate to **prevent the evasion of any provisions of EMIR.**	Third country entity that "**would be subject to the clearing obligation if it was established in the EU**" *provided* the contract has a "**direct, substantial and foreseeable effect within the EU**" or where such an obligation is necessary or appropriate to **prevent the evasion of any provisions of EMIR**.

71 However, Article 3 of EMIR sets out a number of intra-group transactions that may be exempted from the clearing requirement. The exemptions may apply to FCs and NFC+s provided they meet the intra-group requirements.

Under EMIR, the clearing obligation is established by Commission Delegated Regulations based on a draft regulatory technical standard ("**RTS**") developed by the European Securities and Market Authority ("**ESMA**"). Following the first clearing counterparties authorisations in 2014, the process of identification of classes of OTC derivatives has been going-on ever since.

To date, the European Commission (the "**Commission**") has already approved three RTSs covering two different classes of assets: OTC interest rate derivatives and OTC credit derivatives. The Public Register for the Clearing Obligation[72] includes the classes of OTC derivatives that central counterparties ("**CCPs**") are authorised to clear. The classes of OTC derivatives subject to the clearing obligation are also listed in the Public Register once the process is finalised, i.e. after the publication of the relevant RTS in the Official Journal of the EU.

G4 Currency Interest Rate Swaps

To date, ESMA has been notified of four classes of interest rate OTC derivatives denominated in a G4 currency that certain CCPs have been authorised to clear. ESMA launched a public consultation on 11 July 2014[73] and on October 2014 submitted to the Commission its final report and RTS proposal[74] to impose a clearing obligation on various classes of interest rate swaps denominated in the G4 currencies (EUR, GBP, JPY and USD). Subject to the relevant Category (please see below), the EMIR clearing obligation for the following G4 interest rate swaps commenced from 21 June 2016, under the Commission's Delegated Regulation 2015/2205 of 6 August 2015 (the "**G4 IRS RTS"**):

(a) Fixed-to-floating interest rate swaps (also referred to as plain vanilla)

(b) Floating to floating swaps (also referred to as basis swaps)

(c) Forward Rate Agreements

(d) Overnight Index Swaps

Please see the Annex hereto for a detailed description of the economic parameters of the relevant G4 interest rate swaps that are covered in the G4 IRS RTS.

Non-G4 Currency Interest Rate Swaps

The Commission's Delegated Regulation 2016/1178 of 10 June 2016 (the "**Non G4 RTS"**) is a nearly identical delegated regulation to the G4 RTS but for fixed-to-floating interest rate swaps and forward rate agreements denominated only in Norwegian Krone (NOK), Polish Zloty (PLN) and Swedish Krona (SEK). Initially, the relevant consultation paper for the Non G4 RTS contemplated six EEA currencies (NOK, PLN, SEK, CZK, HUF and DKK)[75] but eventually, the final report included only NOK, PLN and SEK.[76] Although the EU G4 currencies represent a significant share of the total OTC derivatives activity in the EU (around 92%), the segment of the non-G4 currencies can still be relevant.

The Non G4 RTS is based on the G4 IRS RTS but includes the foregoing non-G4 currencies and fewer classes of swaps. Please see the Annex hereto for a detailed description of the economic parameters of the relevant Non G4 interest rate swaps that are covered in the Non G4 RTS.

The Covered Bond Exemption

Both the G4 and the Non G4 RTSs include a provision[77] to exclude contracts concluded with covered bond

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72 Available at: https://www.esma.europa.eu/sites/default/files/library/public_register_for_the_clearing_obligation_under_emir.pdf (21 July 2016)

73 Available at https://www.esma.europa.eu/press-news/consultations/consultation-paper-clearing-obligation-no1-irs

74 Available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2014-1184_final_report_clearing_obligation_irs.pdf

75 Available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2015-807_-_consultation_paper_no_4_on_the_clearing_obligation_irs_2.pdf

76 Available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/esma-2015-1629_-_final_report_clearing_obligation_irs_other_currencies.pdf

77 Article 1 of each RTS.

issuers or with cover pools for covered bonds ("**CBs**"), provided that those contracts satisfy *all* of the following conditions:

(a) they are used only to hedge interest rate or currency mismatches of the cover pool in respect of the CBs;

(b) they are registered or recorded in the cover pool of the CBs;

(c) they are not terminated in case of the resolution or insolvency of the issuer of CBs or the cover pool;

(d) the counterparty ranks at least *pari passu* with the covered bond holders (except if it is the defaulting or affected party or the *pari passu* rank is waived); and

(e) the CB meets the requirements of Article 129 of Regulation (EU) No 575/2013 and is subject to a regulatory collateralisation requirement of at least 102%.

<u>Credit Default Swaps</u>

ESMA opened a consultation[78] on credit defaults swaps on 11 July 2014 and submitted its final report and draft RTS on 1 October 2015.[79] The Delegated Regulation 2016/592 of 1 March 2016 for Credit Default Swaps (the "**CDS RTS**") applies the EMIR clearing obligation to Untranched iTraxx Index CDS (Main, EUR, 5Y) and Untranched iTraxx Index CDS (Crossover, EUR, 5Y). Please see the Annex hereto for a detailed description of the parameters of the two untranched Index CDS classes.

The provisions of the CDS RTS mirror the overall approach of the two IRS RTSs, in particular as regards the categorisation of counterparties, the treatment of intragroup transactions, and the scope of the front-loading requirement.

Categories of Counterparties

Different counterparties need different periods of time to put in place the necessary arrangements to clear the interest rate and credit default OTC derivatives subject to the EMIR clearing obligation. To ensure an orderly and timely implementation of the clearing obligation, counterparties are classified into categories in which sufficiently similar counterparties become subject to the clearing obligation from the same date. Therefore, the EMIR clearing obligation as contemplated in the G4 IRS RTS, Non G4 RTS and CDS RTS takes effect on different dates depending on the classification of the counterparties to the OTC derivative transactions.

Category 1 firms will necessarily have the ability to clear at least one of the classes of OTC derivatives subject to the clearing obligation at an authorised or recognised CCP. Category 2 firms by definition do not necessarily have the ability to clear at least one of the classes of OTC derivatives subject to the clearing obligation at an authorised or recognised CCP

Where firms are unable to determine which category a counterparty belongs to (i.e. either Category 2 or Category 3), ESMA has confirmed that a firm "will assume it is classified in Category 2 for the purpose of compliance with the clearing obligation. In this situation, counterparties should immediately inform their counterparty of the assumption that has been made about them."[80]

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78 Available at: https://www.esma.europa.eu/press-news/consultations/consultation-paper-clearing-obligation-no2-cds

79 Available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1481_final_report_clearing_obligation_index_cds.pdf

80 Questions and Answers, 26 July 2016, ESMA, OTC Answer 24. Available at: https://www.esma.europa.eu/sites/default/files/library/2016-1176_qa_xix_emir.pdf

Category	Types of counterparties	Dates from which the clearing obligation takes effect		
		G4 -IRS	Non G4 IRS[81]	CDS
1	Entities that are clearing members for at least one of the classes of OTC derivatives subject to clearing and included in the relevant RTS	21 Jun 2016	9 Feb 2017	9 Feb 2017
2	Counterparties not belonging to Category 1 which belong to a *group*[82] whose aggregate month-end average of **outstanding gross notional amount** of non-centrally cleared derivatives for January, February and March 2016 **is above EUR 8 billion** and which are any of the following: • an FC; or • an alternative investment fund [83] (as defined in Article 4(1)(a) of Directive 2011/61/EU) that is a NFC	21 Dec 2016	9 Aug 2017	9 Aug 2017
3	Counterparties not belonging to Category 1 or Category 2 which are any of the following: • an FC; or • an alternative investment fund (as defined in Article 4(1)(a) of Directive 2011/61/EU) that is a NFC	21 Jun 2017	9 Feb 2018	9 Feb 2018
4	NFCs that do not belong to Category 1, Category 2 or Category 3.	21 Dec 2018	9 Aug 2019	9 May 2019

Category 1 entities may be either an FC or an NFC, the essential condition being the requirement to be a clearing member. For counterparties which are neither in Category 1 or Category 4, the determination of the category of counterparty depends on the aggregate month-end average of outstanding gross notional amount on non-centrally cleared derivatives for January, February and March 2016 (at group level), as set out above for Category 2. Essentially, the level of activity in OTC derivative contracts will serve as a basis to differentiate the degree of operational capacity of FCs. Category 4 counterparties will invariably be NFC-s.

Where a contract is concluded between two counterparties included in different categories of counterparties, the date from which the clearing obligation takes effect for that contract shall be the later one. Third country entities must determine the category to which they would belong if they were established in the EU.

On 13 July 2016 ESMA published a consultation paper that discusses a new phase-in period for FCs with a limited volume of activity (Counterparty 3) to comply with the EMIR clearing obligation.[84] According to ESMA, Category 3 counterparties are facing important difficulties in preparing the arrangements with clearing

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81 The European Commission published in the Official Journal (21 July 2016) a corrigendum to the Non G4 RTS, which amended the phase-in dates for Category 2 and Category 4 firms from 9 July 2017 and 9 July 2019, to 9 August 2017, and 9 August 2019, respectively. Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1178R(01)&from=EN

82 For the purpose of calculating the group aggregate month-end average outstanding gross notional amount, all of the group's non-centrally cleared derivatives, including foreign exchange, forwards, swaps and currency swaps must be included.

83 Where counterparties are alternative investment funds as defined in Article 4 (1)(a) of Directive 2011/61/EU or undertakings for collective investment in transferable securities as defined in Article 1(2) of Directive 2009/65/EC, the EUR 8 billion threshold will apply individually at fund level.

84 Available at: https://www.esma.europa.eu/press-news/esma-news/esma-consults-proposed-central-clearing-delay-small-financial-counterparties

members that are necessary for clearing the relevant OTC derivative contracts, due to complexities affecting both types of access, client clearing and indirect client clearing, which were not foreseen at the time the proposals related to the clearing obligation were developed. In addition, clearing members' appetite to provide client clearing services beyond their largest clients has been limited. Since EMIR does not contemplate any specific exemption for FCs with limited activity, the additional two year phase-in[85] would ensure that Category 3 firms benefit from a 42 month phase in.

Same Group Exemption

The above dates will not apply in respect of contracts pertaining to a class of OTC derivative contracts as set out in the annex hereto and concluded between counterparties (other than Category 4) that meet the requirements set out in the table below:

Counterparties that are part of the same group	This exemption is contemplated in Art. 3.2 of the G4 RTS, the Non 4G RTS and the CDS RTS and is subject to the following conditions:	
Where one counterparty is established in a third country and the other in the EU	(a)	the third country entity is either a FC or a NFC;
	(b)	the EU counterparty is: (i) a FC, a NFC, a financial holding company, a financial institution or an ancillary services undertaking and the counterparty referred in (a) above is a FC; **or** (ii) either a FC or a NFC and the counterparty referred in (a) above is a NFC;
	(c)	both counterparties are included in the same consolidation basis on a full basis;
	(d)	both counterparties are subject to appropriate centralised risk evaluation, measurement and control procedures; and
	(e)	the EU counterparty has notified its competent authority that the above conditions are met and the competent authority has confirmed so within 30 calendar days.

If the above conditions apply, the date from which the EMIR clearing obligation will apply will be as set out in the table below:

Decision Status	**G4 IRS**	**Non G4 IRS**	**CDS**
If no equivalent decision has been adopted	21 December 2018	9 August 2019[86]	9 May 2019
If an equivalent decision[87] has been adopted, the latter of the following two dates	60 days after the relevant equivalent decision has been adopted		
	The date the relevant clearing obligation takes effect in accordance with the relevant RTS		

Frontloading

Frontloading as foreseen by Article 4(1)(b)(ii) of EMIR is the obligation to clear OTC derivative contracts (pertaining to a class of OTC derivatives that has been declared subject to the clearing obligation) if they have a remaining maturity higher than the *minimum remaining maturity* that are entered into after ESMA has been notified of the authorisation of a CCP and before the date of application of the clearing obligation.

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85 See page 24 of the consultation paper.

86 The European Commission published in the Official Journal (21 July 2016) a corrigendum to the Non G4 RTS, which amended the date specified in Article 3(2)(a), i.e. from 9 July 2019 to 9 August 2019.

87 Pursuant to Article 13(2) of EMIR.

Article 5(2)(c) of EMIR requires ESMA to specify in the relevant RTS the "*minimum remaining maturity of the OTC derivative contracts referred to in Article 4(1)(b)(ii)*". Frontloading does not apply to Category 4 entities.

G4 and Non-G4 Interest Rate Swaps

	G4 Swaps		Non G4 Swaps	
	Class of derivatives	**Minimum remaining maturity**	**Class of derivatives**	**Minimum remaining maturity**
Category 1	Table 1 or Table 2	50 years for contracts entered into or novated before 21 February 2016	Table 1	15 years for contracts entered into or novated before 9 October 2016
	Table 3 or Table 4	3 years for contracts entered into or novated before 21 February 2016	Table 2	3 years for contracts entered into or novated before 9 October 2016
	Table 1 or Table 4	6 months for contracts entered into or novated on or after 21 February 2016	Table 1 or Table 2	6 months for contracts entered into or novated before 9 October 2016
Category 2	Table 1 or Table 2	50 years for contracts entered into or novated before 21 May 2016	Table 1	15 years for contracts entered into or novated before 9 October 2016
	Table 3 or Table 4	3 years for contracts entered into or novated before 21 May 2016	Table 2	3 years for contracts entered into or novated before 9 October 2016
	Table 1 or Table 4	6 months for contracts entered into or novated on or after 21 May 2016	Table 1 or Table 2	6 months for contracts entered into or novated before 9 October 2016
Category 3	Table 1 or Table 2	50 years	Table 1	15 years
	Table 3 or Table 4	3 years	Table 2	3 years

It is very unlikely that frontloading will apply to any Category 3 entity as the minimum remaining maturities are rather long. In any case, NFCs are not subject to frontloading.

Credit Default Swaps

Category 1

Date of OTC contract or novation	Minimum remaining maturity
Before 9 October 2016	5 years and 3 months
On or after 9 October 2016	6 months

Category 2

Date of OTC contract or novation	Minimum remaining maturity
Before 9 October 2016	5 years and 3 months
On or after 9 October 2016	6 months (for contracts that belong to the CDS classes as set out in the Annex hereto)

Category 3

Date of OTC contract or novation	Minimum remaining maturity
N/A	5 years and 3 months, for FCs and intra-group transactions only

Foreign Exchange and Equity Swaps

To date, no specific legislation on these classes of swaps has been passed but consultation papers have already being published for non-deliverable forwards and equity swaps.

ANNEX

OTC derivatives classes subject to the EMIR clearing obligation

G4 Interest Rate Derivatives Classes

Type	Reference Index	Settlement Currency	Maturity	Settlement Currency Type	Optionality	Notional Type
Table 1 - Basis swaps classes						
Basis	Euribor	EUR	28D-50Y	Single currency	No	Constant or variable
Basis	LIBOR	GBP	28D-50Y	Single currency	No	Constant or variable
Basis	LIBOR	JPY	28D-30Y	Single currency	No	Constant or variable
Basis	LIBOR	USD	28D-50Y	Single currency	No	Constant or variable
Table 2 - Fixed-to-float interest rate swaps classes						
Fixed- to- float	Euribor	EUR	28D-50Y	Single currency	No	Constant or variable
Fixed- to- float	LIBOR	GBP	28D-50Y	Single currency	No	Constant or variable
Fixed- to- float	LIBOR	JPY	28D-30Y	Single currency	No	Constant or variable
Fixed- to- float	LIBOR	USD	28D-50Y	Single currency	No	Constant or variable
Table 3 - Forward rate agreement classes						
FRA	Euribor	EUR	3D-3Y	Single currency	No	Constant or variable
FRA	LIBOR	GBP	3D-3Y	Single currency	No	Constant or variable
FRA	LIBOR	USD	3D-3Y	Single currency	No	Constant or variable
Table 4 - Overnight index swaps classes						
OIS	EONIA	EUR	7D-3Y	Single currency	No	Constant or variable
OIS	Fed Funds	USD	7D-3Y	Single currency	No	Constant or variable
OIS	SONIA	GBP	7D-3Y	Single currency	No	Constant or variable

Non G-4 Interest Rate Derivatives Classes

Type	Reference Index	Settlement Currency	Maturity	Settlement Currency Type	Optionality	Notional Type
Fixed-to-float interest rate swaps classes						
Fixed- to- Float	NIBOR	NOK	28D-10Y	Single currency	No	Constant or Variable
Fixed- to- Float	WIBOR	PLN	28D-10Y	Single currency	No	Constant or Variable
Fixed- to- Float	STIBOR	SEK	28D-15Y	Single currency	No	Constant or Variable
Forward rate agreement classes						
FRA	NIBOR	NOK	3D-2Y	Single currency	No	Constant or Variable
FRA	WIBOR	PLN	3D-2Y	Single currency	No	Constant or Variable
FRA	STIBOR	SEK	3D-3Y	Single currency	No	Constant or Variable

Credit Default Derivative Classes

Type	Sub-type	Geographical Zone	Reference Index	Settlement Currency	Series	Tenor
Index CDS	Untranched Index	Europe	iTraxx Europe Main	EUR	17 onwards	5Y
Index CDS	Untranched Index	Europe	iTraxx Europe Crossover	EUR	17 onwards	5Y

European Margin Rules for Non-Cleared OTC Derivatives – Inching Towards the Finish Line

Introduction

As we reported in our June 2016 issue of the Delta Report, in March 2016[88] the European supervisory authorities (the "**ESAs**") adopted a long-awaited draft of the final RTS on margining for non-cleared derivatives (the "**Margin Rules**") appearing to put Europe on track to meet the implementation schedule set out in the BCBS-IOSCO framework (the "**BCBS-IOSCO Framework**"), a major G20 initiative. However, shortly after we went to press, the EU Commission informed the market that it would not have completed its review in time for the phase-in commencement date of 1 September 2016. It would now appear that the EU Commission is working towards approval for the end of 2016 with an envisaged phase-in commencement date of March 2017.[89] At the same time, the Commodities Futures Trading Commission (the "**CFTC**") confirmed there would be no delay in the US and the phase-in would go ahead as planned in September 2016. While the delay in Europe has been welcomed by market participants as the industry struggles with the weight of operational changes and updates to existing, standardised legal documentation, the timing differences are likely to present further challenges to derivatives users trading cross-border.

Developments Since the Final Draft RTS

This article intends to provide readers with an overview of the Margin Rules in Europe following our previous article on the updates contained in the Final Draft RTS. However, in a letter from the EU Commission[90] in July 2016, it was also confirmed that some further changes from that draft would be proposed including:

(a) a new recital justifying the delay of the phase-in of margin requirements for equity options (essentially to prevent arbitrage as neither the US prudential supervisory nor the CFTC rules cover these products);

(b) addressing the concern we highlighted in our June 2016 issue of the Delta Report that for the purposes of cash IM segregation, a custodian in a non-EU jurisdiction *may* be used provided such custodian is equivalent to those in the EU who are regulated under the Capital Requirement Directive ("**CRD**")[91] (the Final Draft RTS had appeared to limit participants to using custodians established in the EU);

(c) clarification that the intra-group transaction exemption can be applied for at any time following entry into force of the Margin Rules;

(d) the removal of concentration limits for pension funds (recognising that liabilities to retirees are usually denominated in a single currency meaning such funds would be required to enter into foreign exchange transactions, introducing costs and a new layer of risks to such funds); and

(e) stating that variation margin ("**VM**") requirements will apply to in-scope physically settled FX forwards from entry into application of the MiFID Delegated Act[92] which is intended to clarify MiFID's scope including for FX forwards (which we understand to be 3 January 2018), or, if the relevant delegated act does not apply by then, by 31 December 2018.

Despite the concerns raised by market participants, no changes have yet been suggested to settlement timing for initial margin ("**IM**") and VM, which for practical purposes continues to be on a T+1 basis. Likewise, no changes have been made to address the treatment of counterparties in non-netting jurisdictions despite some confusion over how these provisions are intended to operate.

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88 http://www.eba.europa.eu/-/esas-publish-final-draft-technical-standards-on-margin-requirements-for-non-centrally-cleared-otc-derivatives (the "**Final Draft RTS**")

89 http://www.bloomberg.com/news/articles/2016-06-09/banks-gain-more-time-to-meet-eu-swap-collateral-regulations

90 http://ec.europa.eu/finance/financial-markets/docs/derivatives/160728-letter-esas_en.pdf

91 Directive 2013/36/EU

92 https://www.esma.europa.eu/policy-rules/mifid-ii-and-mifir

The Margin Rules

Who is affected?

Article 11(3) of EMIR[93] requires financial counterparties ("**FCs**") and non-financial counterparties which exceed the clearing thresholds set out in EMIR ("**NFC+s**") to exchange collateral for uncleared OTC derivatives. Entities in those categories will be required to collect margin from one another, subject to the phase-in thresholds outlined below. The obligation extends to third country entities ("**TCEs**") that would be FCs or NFC+s were they established in the EU.

Are there any exemptions?

Crucially, the Margin Rules do not apply to non-financial counterparties who are below the clearing threshold ("**NFC-s**"). The requirement to post and collect IM will only apply to transactions between two FCs or NFC+s that both (or whose groups both) exceed the relevant thresholds during the phase-in period.[94] Exemptions also apply for:

(a) hedging in covered bond issues (subject to certain conditions);

(b) intra-group transactions;[95]

(c) IM transfer threshold and minimum transfer amounts (see further below);

(d) CCPs entering into derivative contracts to hedge the portfolio of an insolvent clearing member;

(e) IM posting for physically settled FX forwards and swaps or for the exchange of principal and interest in currency swaps (note there is no such flexibility for interest rate swaps or other types of derivatives);[96]

(f) contracts where the premium is paid upfront (although this is only contained in the recitals rather than in substantive provisions of the Margin Rules and will only apply where the portfolio under a netting set consists solely of such contracts); and

(g) as mentioned above, the application of the rules to equity options has been delayed indefinitely to avoid regulatory arbitrage.

Phase-in Timeline

Based on the latest comments from the European Commission, the existing timetable is expected to remain in place with the exception being a delay of six months to the first phase-in for IM and VM. The Phase 1 (see below) effective date is *envisaged* as being February/March 2017. The actual date would be 1 month after entry into force of the Margin Rules (which itself would be 20 days after their publication in the EU's Official Journal).

The "VM for all counterparties" effective date would be the later of 1 March 2017 (so this is aligned with other jurisdictions) or 1 month after entry into force of the Margin Rules. Thus, if the Phase 1 effective date is 1 March 2017 or later (as seems likely), the Phase 1 IM and 'VM for all counterparties' requirements should be implemented simultaneously.

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93 Regulation No 648/2012 of the European Parliament and of the Council.

94 Following the end of the phase-in period, IM will only apply where counterparties have an average total gross notional amount of all uncleared derivatives in excess of EUR 8 billion. This figure (the "Threshold Calculation Method") is calculated across a counterparties group and is as recorded on the last business day of the months of March, April and May of the relevant year.

95 Numerous conditions apply to this carve-out. Broadly, the counterparties must have adequate risk management procedures and there must be "*no current or foreseen practical or legal impediment to the prompt transfer of own funds or repayment of liabilities between counterparties*".

96 Although there is a carve-out for IM, counterparties are still required to post VM under the Margin Rules. However, as in the EU there is no consistent definition of physically settled FX forwards, the Final Draft RTS provides for a delayed implementation date in respect of such contracts that will be between January 2018 and 31 December 2018.

Phase 1 **March 2017**	**Initial Margin** requirements commence where aggregate month-end notional amount exceeds **EUR 3 trillion** **Variation** Margin requirements commence for all counterparties
Phase 2 **September 2017**	**Initial Margin** requirements where aggregate month-end notional amount exceeds **EUR 2.25 trillion**
Phase 3 **September 2018**	**Initial Margin** requirements where aggregate month-end notional amount exceeds **EUR 1.5 trillion**
Phase 4 **September 2019**	**Initial Margin** requirements where aggregate month-end notional amount exceeds **EUR 0.75 trillion**
Phase 5 **September 2020**	**Initial Margin** requirements where aggregate month-end notional amount exceeds **EUR 8 billion**. **End of phase-in.**

Initial Margin

How much IM is required?

The IM calculation is designed to cover current and future potential exposure in the interval between the last exchange of margin and (a) the liquidation of positions following the default of a counterparty and (b) the hedging of that exposure (known as the margin period of risk or MOPR). The Margin Rules provide a standardised method for calculating IM which is based on the BCBS-IOSCO Framework standard tables and also allow for an IM model developed with a third party. However, to achieve consistency and limit potential disputes, the industry has been working on a model – "ISDA SIMM" – tailored to meet the one-tailed 99% confidence internal over a 10-day horizon set by regulators on a uniform basis for market participants. The third party approach/ industry designed model is more flexible and produces less onerous margin requirements than the standard tables (by some estimates the standard tables would increase the amount of margin posted by a factor of 10 to 15 when compared with ISDA SIMM).[97] ISDA SIMM has, however, yet to be approved by regulators.

How often will this need to be collected?

IM must be calculated within 1 business day of certain events including the entry into a new uncleared OTC derivative, the expiry/ removal of such a derivative from the netting set, a payment or delivery (excluding margin) and, in any case, with a backstop of every 10 local business days. Any additional IM would then need to be collected within 1 BD of that calculation being made.

If a party to a transaction has (or its group has) an aggregate month end notional below EUR 8 billion (calculated in accordance with the Threshold Calculation Method) as of the end of the phase-in period, the IM requirements will not apply. The Margin Rules also permit the parties to agree that if the IM requirements between them (and their groups) are below EUR 50 million, then IM need not be collected from a counterparty at group level.

The parties also have the option of agreeing to a minimum transfer amount which is subject to a maximum of EUR 500,000 (or its equivalent in another currency, subject to appropriate recalibration to ensure the level of protection is maintained despite currency fluctuations). Parties may specify separate minimum transfer amounts for IM and VM provided the aggregate does not exceed this figure.

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97 ISDA Quarterly "The ISDA SIMM" http://www.isda-iq.org/category/cover-stories/

Segregation Requirements

The Margin Rules provide that IM must be segregated to protect it from the default or insolvency of the collecting party. As noted in our previous report, the de facto ban on using cash collateral for IM has been removed. This effective ban arose from the requirement that cash be protected via segregation from the default or insolvency of the third party holder or custodian (which is not possible as a custodian acts as banker and not trustee). The Margin Rules now confirm that, although the collecting counterparty may not re-hypothecate, re-pledge or re-use collateral collected as IM, this requirement shall be deemed satisfied where a third party holder or custodian reinvests IM received in cash.[98] However, issues remain with this approach linked to the assessments the counterparty collecting the collateral must make as to the third party holder or custodian's creditworthiness. The segregation requirements also mandate that IM is available to the posting counterparty in a "timely manner" on a default.

Variation Margin

How much VM is required?

VM should reflect the full amount necessary to collateralise the mark-to-market exposure for all non-centrally cleared derivatives in the relevant netting set. Calculating whether that target has been achieved (compared with the collateral already held to cover such exposure) should be done on a daily basis. Where two entities are located in the same time zone, the determination is made as of the previous business day. Where two entities are not located in the same time zone, the determination is made at 4pm as of the previous business day in the earlier time zone.

As mentioned above, the parties can agree to a maximum EUR 500,000 minimum transfer amount to be apportioned between IM and VM. Unlike for IM, there is no threshold for VM so once the minimum transfer amount is exceeded; the full amount will need to be posted.

How often will this need to be collected?

The rules require collection on a T+1 basis. Although there is an option for counterparties to settle VM requirements on a T+2 basis of the calculation in certain circumstances (essentially amounting to a pre-funding of IM), the conditions associated with this option make it rather narrow and onerous meaning market participants are likely, in practice, to be subject to a T+1 deadline.

Restrictions on the type of collateral that may be posted

Eligible Assets (IM and VM)

Assets eligible for use as collateral include cash (or similar, such as money-market deposits), gold, debt securities issued by sovereign and certain public sector entities, equities included on a main index (including related convertibles) and units in UCITS. These classes are subject to certain credit quality and wrong-way risk (i.e. a positive correlation with the creditworthiness of the posting counterparty) tests – see further below. The Margin Rules confirm that IM may be collected in cash as long as it is held in accounts with a Central Bank or a credit institution that is not affiliated with the collateral provider.

Haircuts (IM and VM)

Non-cash collateral is also subject to haircuts, either on the basis of the standardised amounts set out in tables in the Margin Rules or by counterparties own estimates (subject to certain predefined criteria that such estimates must comply with). The standard haircuts range from 0.5% for highly rated sovereign debt to 24% for securitisation positions with a 5 year residual maturity and a rating of between A+ and BBB-.

The standard methodology also includes haircuts of 8% on non-cash collateral posted as VM where it is denominated in a currency other than those agreed in the applicable documents. There is no requirement for any haircut on cash VM but both cash and non-cash IM will be subject to the same 8% haircut where posted in a currency other than the termination currency specified in the trading documentation.

[98] However, it should be noted that this provision is subject to a separate concentration limit, which provides that G-SII's and O-SII's must ensure that where they collect IM from a counterparty that is also a G-SII or O-SII, not more than 20 per cent. of such IM is held in cash by a single third party custodian (See Article 28(5) of the Margin Rules).

Concentration Limits (IM)

Applying only to IM, these limits restrict the proportion of different categories of collateral in order to reduce risk via what is effectively a diversified portfolio strategy. As highlighted in our June 2016 issue of the Delta Report, the concentration limit rules have been significantly simplified from initial drafts of the Margin Rules. The 10% limit on IM from an individual counterparty constituted by corporate bonds or equities of the same issuer or group has been relaxed to the greater of 15% and EUR 10 million (or its equivalent in another currency) although the limit now also applies to securities issued by investment firms and credit institutions (which were previously omitted).

There remains a limit of 40% (but now subject to a limit of EUR 10 million, or its equivalent in another currency) on, cumulatively, certain (a) equities and convertibles issued by institutions subject to CRR[99] (i.e. credit institutions) and (b) securitisation positions, in each case including where those assets are held in UCITS.

Restrictions on certain sovereign debt[100] apply more expansively where both counterparties are (a) considered systemically important by regulators (e.g. G-SIIs or O-SIIs) or (b) counterparties for which the total IM to be collected from an individual counterparty exceeds EUR 1 billion. In such a scenario, a 50% single issuer concentration limit applies. G-SIIs and O-SIIs are also subject, in certain circumstances, to requirements to limit the amount of cash IM collected when transacting with each other and, in the case of G-SIIs and O-SISs only, to obligations to diversity cash IM across more than one custodian. As noted above, proposals are currently being agreed to limit the operational burden of compliance with these concentration limits for pension funds.

Documentation

As a practical matter, one of the key points to address for market participants will be the amendment of existing credit support documentation to bring it into line with the new requirements on eligible collateral, collateral haircuts, timing of calculation and dispute resolution provisions.

The ISDA WGMR has been working to finalise a number of new standard form documents that will comply with the Margin Rules requirements including:

(a) a new English law Credit Support Deed ("**CSD**") for IM (as it is thought there will be a move away from title transfer arrangements given the level of collateral that will need to be set aside – estimated at EUR 200 billion by the ESAs);[101]

(b) a new English law Credit Support Annex ("**CSA**") for VM;

(c) a self-disclosure form that will be available through the recently launched "ISDA AMEND 2.0" (allowing counterparties to determine when they will be required to comply with the margin requirements and make various elections as to what collateral they may provide); and

(d) a Protocol which will update Credit Support Annexes to comply with the requirements in relation to VM.

Market participants should note that although existing transactions are *not* directly affected by the Margin Rules (in that they are not retrospectively subject to their requirements), where existing collateral documentation is amended and used to collect IM or VM for new OTC derivative transactions, in order that any existing transactions and the new transactions can form a single netting set, existing transactions will be brought within the scope of the rules for both IM and VM purposes, assuming the rules would apply to the relevant counterparties and product types being traded.

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[99] Regulation 575/2013 of the European Parliament and of the Council.

[100] See Article 28 in the Final Draft RTS of the Margin Rules. This refers to central government debt, certain other public sector debt and the debt securities of certain multinational development banks and other international organisations (although the carve-out that other public sector debt must be guaranteed in order to fall within the carve out has been removed).

[101] European supervisory authorities, final draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012, page 93, https://www.eba.europa.eu/documents/10180/1398349/RTS+on+Risk+Mitigation+Techniques+for+OTC+contracts+%28JC-2016-+18%29.pdf/fb0b3387-3366-4c56-9e25-74b2a4997e1d

Cross-border Considerations

<u>Non-netting Jurisdictions</u>

A significant improvement in the Final Draft RTS was to address the concern over counterparties located in non-netting jurisdictions.[102] A counterparty will not be required to post any VM or IM for OTC derivatives with counterparties domiciled in such jurisdictions but should still be required to collect margin from those counterparties. Further, there will be no requirement for a counterparty to collect or post VM or IM if the OTC derivatives in a counterparties portfolio do not exceed 2.5% of the total from counterparties in non-netting jurisdictions. However, as we highlighted in our June 2016 issue of the Delta Report, the interpretation and application of these provisions remains unclear and further guidance is awaited.

Cross-border Transactions

The Final Draft RTS state that they are fully aligned with the standards set out in the BCBS-IOSCO Framework. However, it is clear the devil is very much in the detail of the rules both in Europe, the US and in other key jurisdictions. The substituted compliance/ equivalence regimes that have been built into the post-crisis rulebooks were intended to enable market participants to apply comparable foreign rules when trading across borders. This will be particularly important given the CFTC's margin rules could end up applying to a large number of dealers that are also subject to separate overseas requirements http://www.whitecase.com/publications/alert/cftc-issues-final-rules-cross-border-uncleared-swap-margin-requirements?s=margin. The implementation delay in Europe means a substituted compliance determination is unlikely in the near future. Taking the Europe/US arrangements as an example, according to ISDA, "*it seems likely that trades between two phase-one European banks (including those that are non-US CSEs but don't have a US guarantee and aren't classed as foreign subsidiaries under the CFTC margin rules) will now not be required to meet IM and VM requirements until sometime in 2017, when the EU rules come into force*".[103] This could create arbitrage opportunities although it will ultimately depend on the status of each entity and the identity of their counterparties.

Conclusion

The industry has been working hard to ready themselves for the entry into force of this final plank of the post-crisis legislation for derivatives and the finish line is in sight. New standardised documentation in the form of title-transfer and security interest annexes/supplements to the ISDA Master Agreement, protocols, disclosure regimes and Euroclear collateral documentation are all either approaching final form or have already been published. The build-out of ISDA Amend 2.0 and ISDA SIMM should ease the operational and logistical burdens that will inevitably fall on market participants. In the US and other key markets, the rules should be going into action from 1 September. However, although in sight, the finish line will only truly be reached when there is more clarification on the Margin Rules themselves in terms of how they will work in practice (particularly on a cross-border basis) and on how they will impact market liquidity where significant bifurcation in European and US trading has already been observed.

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[102] Jurisdictions in which the legal enforceability of a netting agreement in a third-country cannot at all times be confirmed and/or where the legal review concludes that the effective segregation of IM as per the requirements in the Margin Rules cannot be provided for.

[103] ISDA Quarterly "Cross-Border Challenges" http://www.isda-iq.org/2016/07/09/cross-border-challenges/

Contractual Recognition of Bail-in and the ISDA Article 55 BRRD Protocol

Introduction

The "ISDA 2016 Bail-In Article 55 BRRD Protocol (Dutch/French/German/Irish/Italian/Luxembourg/Spanish/UK entity-in-resolution version)" (the "**Protocol**") was published by the International Swaps and Derivatives Association, Inc. ("**ISDA**") on 14 July 2016. The Protocol is aimed at helping market participants meet a requirement under the European Union Bank Recovery and Resolution Directive ("**BRRD**").[104]

What does the Protocol do?

Under the BRRD regime, resolution authorities in EU member states ("**Member States**") are given a wide range of tools including bail-in powers ("**bail-in**") to write-down and/or convert into equity certain liabilities of failing financial institutions. Entities within the scope of the BRRD (the "**In-scope Entities**") are required under its Article 55 to include a new contractual term (an "**Article 55 Provision**") in any agreement agreed on or after 1 January 2016 that is governed by the laws of a non-EU member state (a "**Third Country Agreement**") with limited exceptions.

The purpose of this requirement is to address a specific concern, namely the enforceability of the exercise of bail-in powers by a resolution authority against counterparties in cross-border transactions where the contract governing the relevant in-scope liabilities is not governed by the laws of a Member State. Within the EEA, the effectiveness of statutory bail-in powers is ensured by the mutual recognition requirements under the BRRD. Beyond the borders of the EEA where mutual recognition does not apply, Article 55 purports to fill the gap by offering a contractual solution whereby the counterparty is held to the agreed contractual terms, thus preventing court challenges in the relevant non-EEA jurisdiction. On the other hand, absent an Article 55 Provision, whether or not the exercise of bail-in powers is effective would need to be assessed under the relevant governing law and the applicable conflict of law principles.

The Protocol only covers the Dutch, French, German, Irish, Italian, Luxembourg, Spanish, and UK bail-in regimes as these were the only Member States which had published final relevant implementation rules at the time of drafting Article 55. By now EU financial institutions will have a clear view as to whether they are In-scope Entities under the BRRD. For In-scope Entities in the applicable jurisdictions, the Protocol offers an efficient way to comply with Article 55 and the related regulatory technical standards. This is achieved by way of the adhering parties ("**Adhering Parties**") amending their existing ISDA Master Agreements and certain other ISDA-sponsored agreements as described in the Protocol ("**Other Agreements**") through deemed incorporation of an Article 55 Provision in the form set out in the Attachment to the Protocol. Other Agreements include for example, other master agreements, framework agreements, securities lending agreements, repurchase agreements, futures agreements and clearing and execution agreements.

What should be included in an Article 55 Provision?

The European Banking Association ("**EBA**") is mandated under Article 55(3) of the BRRD to develop draft regulatory technical standards in order to further determine the contents of an Article 55 Provision ("**Article 55 RTS**"). The Article 55 RTS was published in the Official Journal of the European Union on 8 July 2016 and has been directly applicable in Member States since 28 July 2016. Among other things, the Article 55 RTS sets out certain mandatory requirements for inclusion in an Article 55 Provision.[105]

The Protocol language incorporates these mandatory elements. It (1) provides an acknowledgement and acceptance by the parties to an agreement that certain liabilities created by such an agreement may be subject to bail-in, and (2) evidences agreement by the parties that they will be bound by the exercise of any bail-in powers by the relevant resolution authority in respect of all transactions under such an agreement.

What agreements are covered under the Protocol?

The Protocol amends existing ISDA Master Agreements and Other Agreements between Adhering Parties except in the following circumstances: (1) the parties agree bilaterally that the Protocol does not apply; (2) there are already alternative written agreements existing between the parties which cover the issues and substance of the Attachment to the Protocol; (3) the relevant resolution authority determines that the relevant liabilities may be subject to bail-in pursuant to the laws of the third country governing such liabilities or a

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[104] Directive 2014/59/EU 15 May 2014.

[105] Article 55 RTS, Article 44: "Contents of the contractual term required by Article 55(1) of Directive 2014/59/EU".

binding agreement concluded that such third country laws together with the relevant implementation legislation has been amended to reflect such determination; or (4) the relevant implementation legislation has been repealed or amended in a manner that the requirement for contractual recognition of bail-in is removed.

All Adhering Parties must adhere to the Protocol in its entirety. Partial adherence is not permitted. The Protocol will apply to all ISDA Master Agreements and Other Agreements between any two Adhering Parties that are entered into on or prior to the Implementation Date provided that the law governing such agreement is that of a non-EU member state**.** "Implementation Date**"** is broadly defined in the Protocol as the later date upon which either of the two relevant Adhering Parties delivers an Adherence Letter in the form prescribed under the Protocol. Any new documentation entered into after the Implementation Date will need to expressly incorporate the Protocol terms in the documentation.

The types of agreements covered under the Protocol ("**Protocol Covered Agreements**") are wide in scope and broadly include:

(a) ISDA Master Agreements (including any deemed ISDA Master Agreement arising pursuant to the execution of a confirmation), any outstanding Transactions thereunder and any outstanding Credit Support Documents entered into by such Adhering Parties in connection therewith; and

(b) other master agreements, framework agreements, master netting or set-off agreements or agreements incorporating master trading terms by reference where such terms may cause all transactions relating to one or more netting sets to terminate (including where such agreement has been amended or is designed to provide for client clearing, any compensation agreement or execution agreement), in each case may be in writing, electronic format for other agreed official record.

Where there is an express requirement that any amendment or modification to such ISDA Master Agreements and Other Agreements is subject to any consent, approval, agreement, authorisation or other action of any third party, such ISDA Master Agreements and other Agreements shall not be Protocol Covered Agreements unless such consent, approval, agreement, authorisation or other action has been duly obtained.

The Protocol may extend to agreements signed by an investment manager or asset manager as principal and as agent on behalf of its clients. In such circumstances a separate Adherence Letter must be submitted for the principal and for the agent.

The text of the Adherence Letter cannot be altered. Therefore, in cases where an adhering party wishes to amend the Protocol it must revert to bilaterally negotiating and amending the relevant agreements.

When does Article 55 apply?

Any In-scope Entity that is a party to any Third Country Agreement is required to include an Article 55 Provision in the Third Country Agreement, except in the limited circumstances where such Third Country Agreements only create liabilities that are excluded from bail-in ("**Excluded Liabilities**").

The term "liability" is not defined in the BRRD but may be defined in the relevant Member State implementation rules. Article 44(2) of the BRRD sets out the list of Excluded Liabilities, of which "secured liabilities" is probably the most relevant to derivative transactions.

"Secured liabilities" is defined in the BRRD as liabilities "secured by a charge, pledge or lien or collateral arrangements including liabilities arising from repurchase transactions and other title transfer collateral arrangements".[106] However, Article 55 RTS states that "a secured liability shall not be considered as an excluded liability where, at the time at which it is created, it is (a) not fully secured; or (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 Union law or of a third country law achieving effects that can be deemed equivalent to Union law". This creates ambiguity around the precise scope of "secured liabilities", and in light of this, ISDA has advised parties to consider signing the Protocol even if the relevant liability is secured/collateralised. The national rules implementing Article 55 in the relevant Member State will also be relevant, and any party seeking to rely on any exclusion should exercise caution.

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[106] Article 2(1)(67), BRRD.

What are the implementation measures in the United Kingdom?

There is much uncertainty surrounding the precise scope of the application of the Article 55 requirements, with the details left to each implementing regulator. Within the UK the final version of the amended Prudential Regulation Authority ("**PRA**") rules relating to the requirement for contractual recognition of bail-in came into force on 1 August 2016. The published policy statement (PS17/16)[107] contains the final rules on contractual recognition of bail-in (PRA 2016/28)[108] and the final supervisory statement on impracticability (SS7/16).[109] These allow a UK In-scope Entity not to include an Article 55 Provision in a Third Country Agreement where such entity concludes that to do so would be "impracticable". Impracticability is narrowly defined and therefore is unlikely to apply in relation to most derivative transactions.

How may Brexit affect this?

Although still speculative at the current stage, if and when the UK leaves the EU English law will cease to be the law of a Member State. This remains contingent on the outcome of the Brexit negotiations but the UK might fall within the scope of the Article 55 requirement with the result that UK counterparties would need to include an Article 55 Provision when dealing with an In-scope Entity other than in respect of Excluded Liabilities.

What happens to derivative transactions upon bail-in?

Article 49(2) of the BRRD provides that write-down or conversion powers apply only upon or after relevant derivatives have been closed-out. Additionally, Article 49(3) of the BRRD requires that the liability arising from derivative transactions subject to a netting agreement must be determined on a net basis in accordance with the underlying netting agreement.

The regulatory technical standards (C(2016) 2967 final) on the valuations of derivatives for the purpose of bail-in (the **"Derivative Valuation RTS**") were adopted by the European Commission on 23 May 2016 pursuant to Article 49(4) of the BRRD.[110] Broadly speaking, counterparties of In-scope Entities are expected to have limited control over the termination and valuation process and methodology of derivative contracts on any default by the relevant In-scope Entities arising from application of the bail-in tool or other resolution measures. Under Article 3 of the Derivative Valuation RTS, if the bail-in tool is applied to derivative contracts, a resolution authority may specify the criteria it intends to apply when assessing whether replacement trades are commercially reasonable and can force close-out all affected derivative contracts and set a date for valuation.

Derivative counterparties should also be alert to the consequences of the ISDA 2015 Universal Resolution Stay Protocol,[111] the ISDA 2014 Resolution Stay Protocol[112] (together, the "**Resolution Stay Protocols**") and the ISDA Resolution Stay Jurisdictional Modular Protocol[113] (the "**Modular Protocol**") where applicable. The Resolution Stay Protocols and the Modular Protocol, which differ from the BRRD regime in terms of jurisdictional scope and applicability, also have the effect of restricting counterparties' rights by placing a temporary stay on the non-defaulting party's exercise of termination rights in an insolvency situation.

What are the practical implications and challenges of the Article 55 requirement?

Bail-in was developed as a response to the financial crisis and it is intended to, particularly in the event of an EU bank rescue situation, shift the burden and risk of potentially having to write-down, convert or reduce in value certain liabilities from governments and the general public to the creditors and parties to the agreements which created such liabilities in the first place.

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107 PRA Policy Statement (PS17/16) June 2016: "The Contractual Recognition of Bail-In: Amendments to Prudential Regulation Authority Rules".

108 PRA Rulebook, 27 June 2016: "CRR Firms and Non-Authorised Persons: Contractual Recognition of Bail-In Amendment Instrument 2016".

109 PRA Supervisory Statement (SS7/16) June 2016, "The Contractual Recognition of Bail-In: Impracticality".

110 "Commission Delegated Regulation supplementing Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for recovery and resolution of credit institutions and investment firms with regard to regulatory technical standards for methodologies and principles on the valuation of liabilities arising from derivatives."

111 The ISDA 2015 Universal Resolution Stay Protocol published on 4 November 2015.

112 The ISDA 2014 Universal Resolution Stay Protocol published on 4 November 2014.

113 The ISDA Resolution Stay Jurisdictional Modular Protocol published on 3 May 2016.

The rationale underpinning Article 55 BRRD is sound, and contractual recognition of bail-in as a method of addressing cross-border recognition issues is also generally regarded as necessary by financial regulators in order to bridge enforceability gaps where comprehensive national statutory regimes are not yet in place.

The main difficulty with the Article 55 requirement is that it is extremely broad in scope. The fact that BRRD does not set out any definition as to what types of liabilities are subject to contractual bail-in requirements poses significant challenges from an implementation perspective. Furthermore, the BRRD does not mention any specific sanction for breach of bail-in requirements, meaning it may be up to individual member states to set up the relevant frameworks. This uncertainty in scope, the differing legal interpretations of Article 55 within Member States and the layers of legislation at national and EU-levels all contribute to potentially testing times ahead for the BRRD regime. The worst case scenario would be entities having to withdraw trading lines with a reluctant counterparty should negotiations fail.

It is against this backdrop that sector specific bodies such as the ISDA have stepped in to create standard implementation measures or model provisions for specific asset classes. Beyond derivatives, the Association for Financial Markets in Europe, for example, recently released its finalised version of the model clauses for debt and equity instruments. Nevertheless, these initiatives are still seen as interim measures by those who advocate the continuing pursuit of comprehensive statutory recognition, fearing that Article 55 could have an adverse impact on the ability of financial institutions to compete beyond EU borders.

Further developments on the topic of Article 55 BRRD are expected, with some proposing that its scope be revised as part of the review of the minimum requirement for eligible liabilities and own funds under BRRD in order to align it with the guidance of the Financial Stability Board. Others are calling for proportionality requirements to be detailed and for a substantive impact assessment to be carried out. We will continue to watch this space.

Developments in Asia

OTC Derivatives Reporting and Clearing in Hong Kong – A Snapshot

Background

The first phase of the OTC derivatives regulatory regime in Hong Kong commenced in April 2014 with the enactment of the *Securities and Futures (Amendment) Ordinance 2014* (the "**Amendment Ordinance**").[114] The Amendment Ordinance serves as a broad framework which allows for the implementation of mandatory reporting, clearing, trading and record keeping obligations in respect of OTC derivative transactions. On 10 July 2015, the *Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules* (the "**Reporting Rules**") came into effect. The Reporting Rules set out the detailed reporting and related record keeping requirements. The Amendment Ordinance and the Reporting Rules together introduced mandatory reporting in Hong Kong in respect of certain interest rate swaps and non-deliverable forwards ("**Phase 1 Reporting**").

On 30 September 2015, the Hong Kong Monetary Authority (the "**HKMA**") and the Securities and Futures Commission (the "**SFC**") issued a joint consultation paper (the "**Consultation Paper**") to propose the next steps to the OTC derivatives regulatory regime:

(a) mandatory clearing of certain derivative trades ("**Phase 1 Clearing**"); and

(b) expansion of the mandatory reporting requirements ("**Phase 2 Reporting**").

The conclusions of the Consultation Paper (the "**Conclusions Paper**") were published on 6 February 2016 which included a draft of the *Securities and Futures (OTC Derivative Transactions – Clearing and Record Keeping Obligations and Designation of Central Counterparties) Rules* ("**Clearing Rules**").

This article provides a snapshot of the current mandatory reporting and clearing requirements and outlines the key proposals under Phase 2 Reporting and Phase 1 Clearing.

Mandatory Reporting

Requirements for consideration	Phase 1 Reporting	Phase 2 Reporting
When do reporting and record keeping requirements commence?	10 July 2015	Expanded reporting regime under Phase 2 Reporting to commence on 1 July 2017.[115]
Who needs to report and comply with the record keeping obligations?	Each of the following "Prescribed Persons" is subject to the initial reporting requirements:[116] (1) an authorised institution ("**AI**")[117] (2) an approved money broker ("**AMB**")[118] (3) a licensed corporation ("**LC**")[119]	Central counterparties authorised to provide automated trading services ("**ATS-CCP**") will be subject to mandatory reporting in its current form (i.e. Phase 1 Reporting) from 1 September 2016. "Product class" and "product type" classifications are to be removed.

[114] The Amendment Ordinance amended the Securities and Futures Ordinance.

[115] The original commencement date for Phase 2 Reporting was intended to be 1 January 2017.

[116] Note: Fund managers and Hong Kong persons (i.e. persons (other than AIs, AMBs, LCs and central counterparties) that are based in or operating from Hong Kong) are excluded at this stage and are likely to be subject to the Reporting Rules in the future (HKMA and SFC, *Consultation Conclusions and Further Consultation on the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules*, November 2014, paragraphs 17, 21 and Section III(D)).

[117] An authorised institution includes authorised financial institutions incorporated in Hong Kong as well as those incorporated outside Hong Kong (*Reporting Rules*, Rules 11 and 12).

[118] *Reporting Rules*, Rules 9 and 13.

[119] *Reporting Rules*, Rules 9 and 10.

Requirements for consideration	Phase 1 Reporting	Phase 2 Reporting
	(4) a recognised clearing house acting as a central counterparty ("**RCH**")[120] provided that, the Prescribed Person: (1) is a counterparty to the relevant transaction; or (2) in the case of AI, AMB and LC, the relevant transaction was "conducted in Hong Kong"[121] by the Prescribed Person on behalf of its affiliate. and the Prescribed Person is not an "exempt person".[122]	Accordingly the US$30 million limit for "exempt person" relief will be calculated from the whole spectrum of OTC derivative products and not just on a product class basis.
Which products are required to be reported?	(1) Interest rate swaps ("**IRS**"):[123] (a) single-currency IRS (floating v fixed); and (b) single-currency basis swaps (floating v floating), each in currencies and floating rate indices specified by HKMA by notice in the Gazette;[124] and (2) Non-deliverable forwards ("**NDF**")[125] where both the reference currency and the settlement currency are specified currencies specified by HKMA by notice published in the Gazette.[126]	In addition to the products captured under Phase 1 Reporting, all OTC derivative transactions within the 5 key asset classes – interest rate derivatives, FX derivatives, equity derivatives, credit derivatives and commodity derivatives, except that FX forwards entered into for the purposes of buying or selling securities in a foreign currency and which are settled within the settlement cycle[127] for the securities are excluded.
What information needs to be reported?	(1) Retrospective reporting (i.e. backloading) Applies in respect of transactions to which	Backloading will not apply if the transaction is due to mature within one year of the implementation of

120 *Reporting Rules*, Rules 9 and 14.

121 For an AI, AMB and LC, it is required to report a transaction that it has "conducted in Hong Kong" (a) on behalf of an affiliate (in the case of any AI, AMB or LC) or (b) on behalf of its head office or its branch/office outside Hong Kong (in the case of an overseas incorporated AI with a Hong Kong branch). A transaction is regarded as "conducted in Hong Kong" if one of the individuals who made the decision to enter into the transaction was a trader employed or engaged by the reporting entity (irrespective of his/her location at the time of entering into the transaction) and the transaction was entered into on behalf of the relevant Prescribed Person's affiliate (and booked in that affiliate) or the transaction was entered into by the Hong Kong branch of an overseas incorporated AI on behalf of its head office or overseas branch (and booked in such head office or overseas branch) (Reporting Rules, Rule 4. See also SFC, *Frequently Asked Questions on the Reporting Rules*, 10 July 2015, p 11).

122 A Prescribed Person is exempted from the reporting obligation if: (i) the sum of the notional amounts of all of its outstanding OTC derivative transactions within the relevant product class does not exceed US$30 million, (ii) the relevant transaction(s) are not "conducted in Hong Kong" on behalf of the Prescribed Person's affiliate and (iii) in the case of an AI incorporated outside Hong Kong, it is not a counterparty to the relevant transaction and the transaction is not recorded in its principal place of business (outside Hong Kong) or a branch (other than a local branch) of the Prescribed Person.

123 Includes single currency overnight index swaps ("**OIS**") but not forward rate agreements.

124 See Gazette dated 10 July 2015.

125 Excludes FX spot and NDF swap transactions.

126 See Gazette dated 10 July 2015.

127 The settlement period is subject to a T+7 cap (Conclusions Paper, paragraph 135).

Requirements for consideration	Phase 1 Reporting	Phase 2 Reporting
	reporting entities are counterparty and not in respect of transactions that they have "conducted in Hong Kong".[128] (2) Transaction information as set out in Schedule 2 of the Reporting Rules (includes valuation transaction information).	Phase 2 Reporting. Approach to identifying information to be reported changed – data fields for reporting purposes will now be specified by notice in the Gazette. In terms of valuation transaction information, HKMA has clarified that third party valuations are acceptable provided that they are agreed to by both counterparties and calculated on a mark-to-market or mark-to-model basis. Internal valuations are permitted in very limited and exceptional circumstances.
How to report?	Via the electronic reporting system ("**HKTR**") to HKMA.	No change.
Timeline for complying with reporting and record keeping obligations	T+2, subject to any transitional arrangements.	No change.

Mandatory Clearing

Requirements for consideration	Phase 1 Clearing
When do the Clearing Rules commence?	Aimed for implementation on 1 September 2016 (subject to completion of legislative process).
Who is subject to the clearing obligation?	Where at least one of the counterparties to the relevant transaction is a Prescribed Person and the other must either be a Prescribed Person or a financial services provider[129] AND both counterparties (who are Prescribed Persons) have crossed the relevant threshold.[130] Note a proposed exit mechanism from being subject to clearing is contemplated. However it will only be permitted in limited circumstances e.g. if there is a permanent change in the Prescribed Person's business model or trading profile and its positions do not pose a systemic risk concern.[131]
Which transactions are subject to mandatory clearing?	Certain standardised vanilla IRS[132] entered into between major dealers that exceed the threshold specified for that period: (1) fixed-to-floating swaps (with a minimum tenor of 28 days and a maximum tenor of 10 years) – denominated in HKD, USD, EUR, GBP or JPY with floating rate index being HIBOR, LIBOR, EURIBOR, GBP LIBOR and JPY

128 *Reporting Rules*, Rules 9(2), 10(2), 11(2), 12(2), 13(2) and 14(2).

129 "Financial Services Provider" refers only to entities on a list prescribed by the SFC with the HKMA's consent and published in the Gazette (Conclusions Paper, paragraph 76).

130 No clearing threshold will apply in respect of financial service providers (Conclusions Paper, paragraph 76).

131 Conclusions Paper, paragraphs 95-99.

132 IRS entered into pursuant to the exercise of a swaption or created as a result of novation due to restructuring of a corporate group could be subject to clearing but IRS that is/are part of a packaged structure or is/are an embedded feature will not be subject to clearing.

Requirements for consideration	Phase 1 Clearing
	LIBOR respectively; (2) basis swaps (with a minimum tenor of 28 days and a maximum tenor of 10 years) – denominated in HKD, USD, EUR, GBP or JPY with floating rate index being HIBOR, LIBOR, EURIBOR, GBP LIBOR and JPY LIBOR respectively; and (3) OIS (with a minimum tenor of 7 days and a maximum tenor of 2 years) – denominated in USD, EUR or GBP with floating rate index being Fed Funds, EONIA and SONIA respectively.
What is the threshold that applies?	In determining whether the threshold has been crossed, the entire portfolio of OTC derivative transactions (minus deliverable FX forwards and FX swaps) will be taken into account. The calculations will be based on gross notional amounts without netting.[133] The proposed clearing threshold is set at US$20 billion (at least for the next two years) and which will be measured against: (1) in the case of a locally incorporated Prescribed Person, all of its outstanding positions; and (2) in the case of an overseas incorporated Prescribed Person, only those of its outstanding positions booked in the books of its Hong Kong branch.
Timeline for complying with clearing obligation	T+1
Are there any **exemptions or reliefs** that apply?	<u>Intra-group transactions[134]</u> Intra-group transactions are exempted from the clearing obligation if: (1) the transaction is between a Prescribed Person and its affiliate; (2) the accounts of the Prescribed Person and the affiliate are consolidated in full by the holding company and prepared in compliance with the relevant accounting standards applicable to the holding company; (3) both counterparties are subject to centralised risk evaluation, measurement and control procedures; and (4) the affiliate is an "exempt affiliate" i.e. the Prescribed Person has notified either the HKMA or the SFC that the affiliate is to be regarded as an exempt affiliate and such notice remains in force. <u>Jurisdiction-based exemption[135]</u> Transactions booked in one or more pre-identified overseas jurisdictions may be exempted from mandatory clearing if: (1) the relevant transaction is entered into by a Prescribed Person that is not an overseas-incorporated AI or an overseas-incorporated AMB; (2) the relevant jurisdiction is an "exempt jurisdiction" i.e. the Prescribed Person has notified either the HKMA (in the case of an AI or AMB) or the SFC (in the case of an LC) that the jurisdiction in question is to be regarded as an exempt jurisdiction and such notice is still in force; and (3) the aggregate notional amount of relevant OTC derivative transactions

133 Consultation Paper, paragraph 86.

134 Consultation Paper, paragraph 125; Conclusions Paper, paragraphs 108-110.

135 Consultation Paper, paragraphs 130 and 132; Conclusions Paper, paragraphs 111-112.

Requirements for consideration	Phase 1 Clearing
	booked by the Prescribed Person in an exempt jurisdiction does not exceed: (a) in the case of each exempt jurisdiction, 5% of the aggregate notional amount of all relevant OTC derivative transactions entered into by the Prescribed Person (wherever booked), and (b) in the case of all exempt jurisdictions together, 10% of the aggregate notional amount of all relevant OTC derivative transactions entered into by the Prescribed Person (wherever booked).
Is **substituted compliance** permitted?	Yes, in respect of cross-border transactions that meet the following criteria: (1) the transaction is one that is required to be centrally cleared under the clearing requirements of a comparable jurisdiction;[136] and (2) the transaction must have been cleared through one of the designated central counterparties ("**CCPs**")[137] and in accordance with the laws of that comparable jurisdiction.

136 The initial list of "comparable jurisdictions" are members of the OTC Derivatives Regulators Group which are Australia, Brazil, Canada, Member states of the European Union, Japan, Singapore, Switzerland and the United States (Consultation Paper, paragraph 155).

137 It is anticipated that both local and overseas CCPs may become designated CCPs for the purposes of the clearing obligation. The relevant CCP must also be a RCH or an ATS under the regime.

Proposed Margin Requirements for Uncleared OTC Derivatives in Singapore

Background

As part of the G20's global reform programme to reduce the systemic risk from over-the-counter ("**OTC**") derivatives, the Basel Committee on Banking Supervision ("**BCBS**") and the International Organization of Securities Commissions ("**IOSCO**") were called upon to establish global requirements for the margining of non-cleared OTC derivatives. In its March 2015 report[138] (the "**March Report**"), BCBS-IOSCO outlined a comprehensive policy framework which, among other things, imposed requirements relating to the exchange of variation margin ("**VM**"), bilateral transfers of initial margin ("**IM**"), segregation of IM and limiting eligible collateral to only highly liquid assets. These requirements will impact a large number of financial institutions which are trading uncleared OTC derivatives globally and require them to make significant front-to-back infrastructure changes as well as negotiate collateral agreements to put in place the necessary margining arrangements.

The deadline for implementation of the margining requirements as set by BCBS-IOSCO was 1 September 2016. However, in June 2016 the European Commission announced that it was still reviewing the draft regulatory standards submitted by the European Supervisory Authorities and that the standards will not be finalised before the 1 September 2016 deadline.[139] Soon after, regulators in Hong Kong, Singapore and Australia also announced their intentions to delay the collateral requirements for non-cleared OTC derivatives in their respective countries.[140]

Introduction

On 1 October 2015, the Monetary Authority of Singapore ("**MAS**") issued a consultation paper titled "Policy Consultation on Margin Requirements for Non-Centrally Cleared OTC Derivatives" (the "**Consultation Paper**"). The Consultation Paper sets out MAS' policy proposals for the implementation of the margining regime in Singapore which will be effected via new rules. It is anticipated that MAS will release a subsequent consultation paper seeking feedback on the proposed new rules.

This article provides an overview of some of the key points raised in the Consultation Paper.

MAS' Policy Proposals on the Margin Requirements

Requirements for Consideration	Proposed Margin Requirements	
Which entities are subject to the margin requirements?[141]	1. Banks licensed under the *Banking Act* ("**Licensed Banks**"); 2. Merchant banks approved as financial institutions under Section 28 of the *MAS Act* ("**Approved Merchant Banks**"); and 3. Other licensed financial institutions licensed under the *Finance Companies Act*, *Insurance Act*, *Securities & Futures Act* ("**SFA**") and *Trust Companies Act* (including fund managers that are legal counterparties) if each of their relevant exposures exceeds the threshold, (each a "**MAS Covered Entity**"), provided that such MAS Covered Entity conducts regulated activities under the SFA.	Exemptions: Sovereigns, central banks, public sector entities, multilateral development banks and the Bank for International Settlements

[138] BCBS-IOSCO, "Margin Requirements for Non-centrally Cleared Derivatives" (March 2015).

[139] Practical Law, "*EU Delays Margin Rules for Uncleared Swaps*" (22 June 2016).

[140] http://www.thetradenews.com/Regulation/Australia,-Hong-Kong-and-Singapore-delay-swaps-margin-rules/ (accessed on 28 august 2016).

[141] For a start, only Licensed Banks and Approved Merchant Banks are phased in. See "phase-in implementation" below.

Requirements for Consideration	Proposed Margin Requirements	
	MAS has not determined whether investment funds domiciled in Singapore will be subject to the margin requirements. An investment fund is considered to be distinct and separate only if the fund is (1) a distinct segregated pool of assets for the purposes of fund insolvency or bankruptcy; and (2) not collateralised or guaranteed by another person.	
Which transactions are subject to the margin requirements?	All OTC derivative contracts not centrally cleared by a qualifying central counterparty.	Exemptions: Physically-settled FX forwards and FX swaps[142] Note: MAS Covered Entities may also apply for exemption of intra-group transactions.[143]
What conditions must be met for the margin requirements to apply?	1. The MAS Covered Entity is a legal counterparty (i.e. a signatory to the ISDA Master Agreement and the related collateral agreement) to the transaction; 2. The transaction is booked in Singapore; and 3. The transaction is entered into with either an MAS Covered Entity or an overseas regulated financial firm.	
Bilateral or unilateral margining	MAS is considering imposing a unilateral "collect-only" requirement on MAS Covered Entities (as opposed to a bilateral "post-and-collect" requirement under the BCBS-IOSCO framework which involves counterparties exchanging collateral).[144]	Deemed compliance possible in cross-border transactions where another jurisdiction's margin requirements apply.[145]
IM requirements	IM shall be collected (or exchanged) at the outset of a transaction and thereafter, gross margining (no netting of IM payments between the counterparties) on a sufficiently regular basis to reflect changes in risk positions and market conditions, subject to a Minimum Transfer Amount of S$800,000. Threshold of S$80 million (calculated at group-consolidated level and is based on all uncleared derivatives between the two consolidated groups), subject to phase-in thresholds (see below).	

[142] Note that the relevant entities are still expected to appropriately manage the risks associated with such FX transactions (Consultation Paper, paragraph 3.2).

[143] This is subject to the condition that the MAS Covered Entity comes under group-wide supervision by MAS or regulators in other jurisdictions.

[144] A collect-only regime would allow parties to avoid any operational challenges in relation to bilateral collateral exchanges for cross-border transactions, particularly where there are conflicting requirements between jurisdictions e.g. differences in collateral eligibility or where the other jurisdiction is not a "netting-friendly" jurisdiction.

[145] In such situations, the MAS Covered Entity is deemed compliant if it (1) has complied with the relevant foreign jurisdiction's requirements which are comparable to those of MAS or (2) has complied with comparable margin requirements imposed on its foreign counterparty.

<table>
<tr><th>Requirements for Consideration</th><th>Proposed Margin Requirements</th></tr>
<tr><td>VM requirements</td><td>Daily margining with zero threshold, subject to a Minimum Transfer Amount of S$800,000.

Collection (or exchange, if MAS adopts a post-and-collect regime) within 2 business days following the execution of a new uncleared derivative contract.</td></tr>
<tr><td>Eligible collateral and haircuts</td><td>
<table>
<tr><th colspan="3">Asset Type[146]</th><th>Haircut[147]</th></tr>
<tr><td colspan="3">Cash (in the same currency as the settlement currency)</td><td>0%</td></tr>
<tr><td colspan="3">Gold</td><td>15%</td></tr>
<tr><td></td><td></td><td>Residual maturity</td><td></td></tr>
<tr><td rowspan="7">Central bank and government issuers</td><td rowspan="3">Debt securities (AAA to AA-)</td><td><= 1 year</td><td>0.5%</td></tr>
<tr><td>>= 1 year and <= 5 years</td><td>2%</td></tr>
<tr><td>> 5 years</td><td>4%</td></tr>
<tr><td rowspan="3">Debt securities (A+ to BBB-)</td><td><= 1 year</td><td>1%</td></tr>
<tr><td>>= 1 year and <= 5 years</td><td>3%</td></tr>
<tr><td>> 5 years</td><td>6%</td></tr>
<tr><td>Debt securities (BB+ to BB-)</td><td>All maturities</td><td>15%</td></tr>
<tr><td rowspan="6">Other issuers</td><td rowspan="3">Debt securities (AAA to AA-)</td><td><= 1 year</td><td>1%</td></tr>
<tr><td>>= 1 year and <= 5 years</td><td>4%</td></tr>
<tr><td>> 5 years</td><td>8%</td></tr>
<tr><td rowspan="3">Debt securities (A+ to BBB-)</td><td><= 1 year</td><td>2%</td></tr>
<tr><td>>= 1 year and <= 5 years</td><td>6%</td></tr>
<tr><td>> 5 years</td><td>12%</td></tr>
<tr><td colspan="3">Equity securities in a main index of a securities exchange in Singapore or recognised Group A exchanges[148]</td><td>15%</td></tr>
<tr><td colspan="3">Haircut for currency mismatch between collateral currency and settlement currency</td><td>8%</td></tr>
</table>
MAS Covered Entities should ensure that the collateral collected is not overly concentrated in an individual issuer, issuer type or asset type.</td></tr>
</table>

146 Any reference to debt securities and equity securities, as the case may be, in this section excludes securities issued by the MAS Covered Entity or its related entities.

147 The haircuts shown in this table are the schedule-based haircuts proposed by MAS. However in addition to these schedule-based haircuts, MAS also permits the use of risk-sensitive model-based haircuts (whether developed in-house or by a third party), subject to MAS' approval.

148 Group A exchanges are securities exchanges in Australia, Austria, Belgium, Canada, France, Germany, Hong Kong, Italy, Japan, Malaysia (except Labuan), Netherlands, New Zealand, South Korea, Spain, Sweden, Switzerland, Taiwan, Thailand, United Kingdom and United States.

Requirements for Consideration	Proposed Margin Requirements
Segregation of IM	IM collateral collected should be segregated in one of the following ways: 1. Held with an independent third party custodian under a trust arrangement; or 2. Held under other legally enforceable arrangements where the IM collateral is legally segregated from the collecting party's proprietary money and assets.
Re-hypothecation, re-pledge and re-use of collateral	Non-cash IM may be re-hypothecated to a third party, subject to such arrangement that meets MAS' proposed conditions which include, among other things, the IM collector is subject to regulation of liquidity risk, the collateral is treated as a customer asset, the third party recipient of the collateral is prohibited from further re-hypothecating and the level and volume of re-hypothecation must be disclosed to MAS. No restrictions on VM collateral.

Margin Calculations and Methodologies

How much IM is required?

To calculate the IM required based on a one-tailed 99% confidence interval over a 10-day horizon,[149] MAS Covered Entities may use either (i) a more risk-sensitive quantitative portfolio margin model or (ii) a standardised margin schedule proposed by MAS.[150]

Any use of quantitative portfolio margin models (whether developed in-house or by a third party) must meet the following conditions:

(a) the MAS Covered Entity must supply the relevant documentation and get the model approved by MAS (including any third party-provided models). If the initially approved model ceases to comply with MAS' requirements, the MAS Covered Entity shall notify MAS and calculate its IM based on the standardised margin schedule;

(b) the model must be subject to the MAS Covered Entity's internal governance process and independently validated before being used and annually thereafter;

(c) the model must be recalibrated at least every 6 months and be subjected to regular back and stress testing programmes.

Quantitative IM models may account for risk on a portfolio basis provided that the uncleared derivatives that are included for use in the same model calculation are subject to a single, legally enforceable netting agreement. Otherwise, if there is no such single netting agreement, the IM requirement of each of the derivatives contracts should be calculated using distinct IM models and each IM requirement is to be posted or collected on a gross basis.[151]

At a minimum, the IM ought to be recalculated and collected (or exchanged) when a new contract is executed with a counterparty, an existing contract with a counterparty expires, the IM model is recalibrated due to changes in market conditions or no IM recalculation has been performed in the last 10 days.

149 The horizon period is subject to the frequency of VM margining. If VM margining is less than daily, the minimum horizon should be set equal to 10 days plus the number of days in between VM collection.

150 MAS does not impose a restriction that the initially selected approach will apply throughout the entirety of the MAS Covered Entity's s derivatives activities however MAS notes that the MAS Covered Entity's should make a consistent choice over time at least for all transactions within the same asset class (Consultation Paper, paragraph 5.3).

151 Consultation Paper, paragraph 5.7(a).

How much VM is required?

The amount of VM required must be sufficient to fully collateralise the mark-to-market exposure of the relevant uncleared derivatives transactions that are subject to the margin requirements.

The VM to be posted or collected shall be calculated on an aggregate net basis across all uncleared derivatives subject to a single, legally enforceable netting agreement. If there is no such netting agreement, the VM should be calculated on a gross basis.

Phase-in Implementation Schedule

As there are significant operational and system adjustments that need to be made to accommodate these new margining requirements, MAS has proposed a phasing in of the requirements which shall apply to Licensed Banks and Approved Merchant Banks initially.

Each of the VM and IM requirements applies only to new contracts entered into after the relevant Commencement Date where the MAS Covered Entity is facing another covered entity whose group exceeds the same threshold. IM for existing uncleared derivative contracts is not mandatory. For the purposes of calculating whether the threshold has been exceeded, the calculations are based on the numbers of the group to which the relevant MAS Covered Entity belongs, such numbers being the group's aggregate month-end average notional amounts for all of the group's uncleared derivatives, including physically settled FX forwards and FX swaps ("**Group's Aggregate Notional**").

MAS has proposed a 6-month transition period from the respective Commencement Date to allow MAS Covered Entities sufficient time to be operationally ready to implement the relevant requirements. Given the delay in commencement as announced by the MAS, the relevant commencement dates reflected in the Consultation Paper are likely to be amended accordingly.

Phase-in implementation schedule – VM requirements	**MAS Covered Entity**	**Threshold**	**Commencement Date**
	Licensed Banks	S$4.8 trillion[152]	1 Sep 2016
	Licensed Banks and Approved Merchant Banks	No threshold applies	1 Mar 2017
Phase-in implementation schedule – IM requirements	**MAS Covered Entity**	**Threshold**	**Commencement Date**
	Licensed Banks	S$4.8 trillion[152]	1 Sep 2016
	Licensed Banks and Approved Merchant Banks	S$4.8 trillion[152]	1 Mar 2017
	Licensed Banks and Approved Merchant Banks	S$3.6 trillion[153]	1 Sep 2017
	Licensed Banks and Approved Merchant Banks	S$2.4 trillion[154]	1 Sep 2018
	Licensed Banks and Approved Merchant Banks	S$1.2 trillion[155]	1 Sep 2019
	Licensed Banks and Approved Merchant Banks	S$13 billion[156]	1 Sep 2020

[152] Calculated on the Group's Aggregate Notional for March, April and May 2016.
[153] Calculated on the Group's Aggregate Notional for March, April and May 2017.
[154] Calculated on the Group's Aggregate Notional for March, April and May 2018.
[155] Calculated on the Group's Aggregate Notional for March, April and May 2019.
[156] Calculated on the Group's Aggregate Notional for March, April and May of the relevant year.

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