Banking / Capital Markets

The Delta Report

Derivatives Newsletter

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In this first issue of The Delta Report for 2017, we cover crucial updates on developments in the derivatives space in Europe and Asia. In the UK, Brexit-related issues continue to take the spotlight. The Article 50 challenge before the UK Supreme Court has created uncertainty as to whether the UK government will be able to retain its original Brexit timeline of March 2017. Another key topic on everyone's lips – margining. Undoubtedly, 2017 is going to be the year of "margining". On 4 January 2017 the rules governing the mandatory posting of collateral for uncleared derivatives entered into force in Europe. The key date to watch out for is 1 March 2017 – all in-scope counterparties will be obliged to post variation margin in Europe and Singapore.

Annual "Hot Topics in Derivatives" Seminar

Each year, White & Case hosts a "Hot Topics in Derivatives" seminar for our clients conducted live from our London office (and via videoconference in other offices including New York and Singapore). The topics covered in each of the seminars focus on key regulatory developments and updates that are relevant to our clients in the derivatives industry. Through our seminars, we aim to give practitioners practical insight and keep them at the forefront of global developments in the derivative space.

On 17 November 2016, lawyers from our London and New York teams led by partners, Ian Cuillerier and Ingrid York, presented on key topics in the industry which included:

(a) US and EU Margin rules and new ISDA documentation that has resulted from the new rules;

(b) updates and ISDA Protocols based on bank resolution regimes in the US and EU;

(c) an update on Brexit; and

(d) various other regulatory updates, particularly in the US and EU.

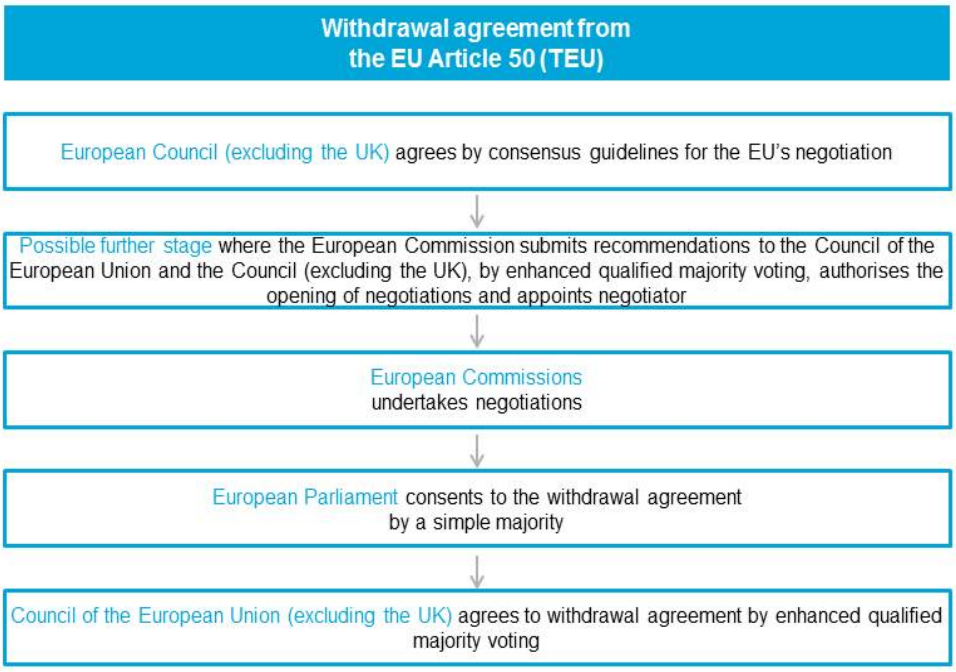
For this year's seminar, we will continue to bring you in-depth insight and further updates on the fundamental changes taking place across the globe.

Developments in Europe

Brexit update: the Article 50 Challenge, the Great Repeal Bill and Issues around Timing

Introduction

There is still much uncertainty surrounding the timing and process by which the United Kingdom ("**UK**") would officially commence the "departure process" by invoking Article 50 of the Treaty on European Union ("**TEU**") ("**Article 50**") following the EU referendum result on 23 June 2016.



Source: HM Government, "*The Process for withdrawing from the European Union*", February 2016

Prime Minister Theresa May said in a Conservative party conference in November 2016 that she would trigger the exit negotiation process by the end of March 2017.[1] This intention of the UK government (the "**Government**") was reiterated by the Secretary of State for Exiting the European Union (the "**Secretary of State**"), David Davies, in his statement to Parliament on 7 November 2016.[2] This would effectively mean that the UK will leave the EU by March 2019, unless there is a unanimously agreed extension of the standard two-year period. However, a current UK court challenge on the Government's power to trigger Article 50 without parliamentary approval has thrown into question the likelihood of the Government being able to retain its original Brexit timeline. So far, the Government has not made it clear as to how the outcome of the court case would affect its plan.

EU Treaty provisions

Article 50 (1) TEU states: "Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements". Article 50 (2) TEU states: "A Member State which decides to withdraw shall notify the European Council of its intention".

Article 50 Treaty on European Union

1. Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.
2. A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. That agreement shall be negotiated in accordance with Article 218(3) of the Treaty on the Functioning of the European Union. It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the

[1] The Prime Minister, Theresa May, speaking on 2 November 2016 at the Conservative Party Conference at The ICC, Birmingham, "*The good that Government can do*".

[2] Oral statement to Parliament delivered by David Davies on 7 November 2016, see "*A statement from the Secretary of State for Exiting the European Union on the process for invoking Article 50*".

European Parliament.

3. The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred to in paragraph 2, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.
4. For the purposes of paragraphs 2 and 3, the member of the European Council or of the Council representing the withdrawing Member State shall not participate in the discussions of the European Council or Council or in decisions concerning it. A qualified majority shall be defined in accordance with Article 238(3)(b) of the Treaty on the Functioning of the European Union.
5. If a State which has withdrawn from the Union asks to rejoin, its request shall be subject to the procedure referred to in Article 49.

Article 50 court challenge

In the recent case of *R (on the application of Miller & Dos Santos) v Secretary of State for Exiting the European Union*[3] (the "**Article 50 Case**"), the Divisional Court ("**DC**") ruled in its judgment dated 3 November 2016 that the Government does not have power under the Crown's prerogative to give notice pursuant to Article 50 for the UK to withdraw from the EU. Therefore, Parliament will have to vote on authorising the Secretary of State to trigger Article 50 which would inevitably repeal the European Communities Act 1972 ("**ECA 1972**").

In reaching its decision, the DC rested its ruling on two important constitutional principles. Firstly, the Crown cannot use its prerogative powers to alter domestic law and that the prerogative powers of the Crown are subject to "*the overriding powers of the democratically elected legislature as the sovereign body*".[4] In particular, the DC was of the view that (1) the wide and profound extent of the legal changes in domestic law created by the ECA 1972 makes it especially unlikely that Parliament intended to leave their continued existence in the hands of the Crown; (2) Parliament, having taken the major step of switching on the direct effect of EU law in the national legal systems by passing the ECA 1972 as primary legislation, could not have intended that the Crown should be able to switch this off again through unilateral action under its prerogative powers; and (3) being a statute of major constitutional importance, the ECA 1972 should be exempt from casual implied repeal by Parliament. Secondly, the Crown's prerogative powers operate only on the international plane.

The DC considered that it is clear Parliament intended EU rights to have effect in domestic law and that this effect should not be capable of being undone or overridden by action taken by the Crown in exercise of its prerogative powers. The ECA 1972 cannot be regarded as silent on the question of what happens to EU rights in domestic law if the Crown seeks to take action on the international plane to undo them. It either does or does not reserve power to the Crown (including giving notice under Article 50) and DC was of the view that the ECA 1972 clearly does not. Interestingly, the DC further stated that the European Union Referendum Act 2015 ("the **Referendum Act 2015**") must be interpreted in such a way which leads to the conclusion that a referendum on any topic can only be advisory unless there is clear language to the contrary in the Referendum Act 2015 itself.

The UK Supreme Court carried out a four-day hearing[5] on the appeal of the Article 50 Case in December 2016 with final judgment expected later this month.

The Appellant (the Secretary of State) has submitted that the DC was wrong to uphold the Respondents' (Miller and Dos Santos) claims and rests its case on a number of key arguments, which are set out in summary terms as follows:[6]

[3] [2016] EWHC 2768.

[4] Ibid [86].

[5] The hearing dates were 5th – 8th December 2016.

[6] Appellant's Case, On Appeal from the High Court of Justice Queen's Bench Division (Divisional Court), UKSC 2016/196, in the Supreme Court of the United Kingdom.

(a) Within the UK's constitution, the power of the Government to exercise its prerogative powers on the international law plane is long established and a vital modern necessity.

(b) The UK has a dualist constitutional system (prerogative actions of the Government on the intentional law plane on one hand and the Parliament giving effect as necessary to the rights and obligations on the domestic plane on the other) and where Parliament has chosen to implement treaty rights and obligations through legislation, that fact carries no implicit restriction on how Government should or must later act in relation to those treaties on the international plane.

(c) When Parliament wishes to impose forms of prior control upon the Government's prerogative powers to enter into or withdraw from treaties, it must make its intention clear. The ECA 1972 is a conduit by which the relevant treaty rights and obligations are given effect in domestic law, but carries no implication about any future action or decision on the international plane. Moreover, these domestic legal rights and obligations existing through such a conduit from time to time are contingent on alterations by the Government through the exercise of its prerogative powers on the international plane.

(d) The *De Keyser* principle[7] should be applied in considering whether the Government's prerogative powers relating to the conduct of foreign affairs (including the making and un-making of treaties) have been removed either through express abrogation or by necessary implication. Parliament has considered with care and in detail the nature of controls over the exercise of prerogative powers in the context of treaties generally but also specifically in the context of changes to the EU legal regime and has evinced no such intention on the many opportunities it has had, including in the Referendum Act 2015.

The Respondents (also Claimants) have made the written submissions to the Supreme Court that the Appellant's case suffers from several main errors of analysis, namely that (1) the Appellant fails to recognise the exceptional nature of the ECA 1972 and its effect on the dualist principle (distinguishing domestic and international law so that action on the international plane does not affect the content of domestic law); (2) the Appellant fails to recognise certain fundamental principles of domestic law[8] which support the case that Parliament cannot have intended when enacting the ECA 1972 to authorise the Government by the use of prerogative to take action or defeat or frustrate the rights Parliament has created.[9]

The Respondents have put forward their alternative case that notification under Article 50(2) is unlawful without statutory authorisation by an Act of Parliament by stating that:

(a) Parliament created statutory rights under the ECA 1972, with their scope and effect being determined with binding effect by an international court. For the Secretary of State to give notification under Article 50(2) TEU that the UK intends to withdraw from the EU would cause those statutory rights to be destroyed or frustrated.

(b) The ECA 1972 is a piece of "constitutional" legislation of fundamental importance which means that it can only be repealed by a deliberate and express provision. In this case only Parliament could defeat the statutory rights which Parliament itself has created. Parliament did not intend that the rights it had created could be defeated or frustrated by the actions of a Government minister purporting to exercise prerogative powers. In any event, the Government has no prerogative power at common law to take action which will defeat those rights. Clear statutory authority is required.

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[7] *Attorney-General v De Keyser's Royal Hotel Ltd* [1920] AC 508.

[8] Such principles include (i) Parliamentary sovereignty which means that the prerogative power to enter into and terminate treaties may not be used to defeat or frustrate domestic law rights created by Parliament; (2) even a statutory power to alter primary legislation by delegated legislation will be narrowly construed, all the more so when a prerogative power is replied upon; (3) a statute is construed as defeating rights only when Parliament has clearly so provided, all the more so when the dispute concerns the scope of prerogative power; and (4) the special constitutional status of the ECA 1972 means it is exempt from the doctrine of implied repeal by the enactment of later inconsistent legislation and for the same reason cannot be subject to removal by the exercise of prerogative power.

[9] Written Case for the Lead Claimant, Mrs Gina Miller, on appeal from the High Court of Justice Queen's Bench Division, in the Supreme Court of the United Kingdom.

Both the Appellant and the Respondents further developed their arguments through oral submissions in front of eleven Justices of the Supreme Court. The arguments mounted were complex and interesting, and we note in particular the emphasis of the oral submissions on examining the very nature of Parliamentary supremacy itself and whether it can constitutionally demonstrate that supremacy by either action, inaction, or both. Much also rests on the proper reading of the UK "dualist system", and whether legislation is merely a conduit for the contingent rights and obligations developed on an international plane, or whether it provides the ultimate source of authority for the creation, alteration and removal of such rights and obligations, thereby rendering any attempt to frustrate or destroy the same through the prerogative illegal. We will provide a further update in due course when further details on this landmark case are revealed.

The "Great Repeal Bill"

Of crucial importance is the announcement by Theresa May that a "Great Repeal Bill" (the "**Bill**") will soon be put before Parliament which will "*remove from the statute book – once and for all – the European Communities Act*".[10] The Bill will be included in this year's Queen's Speech (scheduled for May 2017) meaning that the ECA 1972 will no longer apply from the date upon which the UK formally leaves the European Union and simultaneous, the Bill will transpose the '*acquis*' (which is the body of existing EU law) into British law.[11] The Bill will include powers for ministers to alter the *acquis* by secondary legislation, meaning that pending the Bill being given Royal Assent, Parliament "*will be free – subject to international agreements and treaties with other countries and EU on matters such as trade – to amend, repeal and improve any law it chooses*".[12]

It has been argued that there are several potential issues associated with this plan:

(a) When section 2(1) of the ECA 1972 (which currently provides that EU law provisions which are directly applicable or have direct effect are automatically binding without further enactment) is repealed, EU law provisions which have not been separately implemented (e.g. Regulations such as EMIR and MiFIR) will disappear unless there is a separate provision enacted incorporating them into national law. To incorporate Regulations wholesale may cause great political unease, but a more tailor-fit plan would be complex and time-consuming. It is questionable whether this can be completed before the introduction of the Bill this Spring.

(b) The Bill will include powers for ministers to alter the *acquis* by subordinate legislation. Using such powers could become a critical issue both from a constitutional and political perspective.

(c) Once the UK legal system is severed from the EU legal system, keeping up with a "living" body of *acquis* which is frequently consolidated, amended and/or supplemented by legislative activity may be particularly challenging. It has been argued that there is a risk that UK ministerial resources will be expended on assessing any updates and refreshers to EU laws. The process will be particularly challenging where the UK is hoping to establish "equivalence"[13] to the EU regime.

(d) Issues could also arise regarding the current jurisdiction of EU institutions, such as the European Court of Justice (the "**ECJ**"), the European Securities and Markets Authority ("**ESMA**"), the European Banking Authority ("**EBA**") and European Commission, which will not have jurisdiction over the UK. It has been argued that the Bill must transpose existing Regulations in such a way that the provisions would still make sense without references to the jurisdiction of EU institutions.

(e) There is much uncertainty as to whether the body of ECJ cases will remain persuasive as precedents in the UK court system. This is both in relation to any transposed *acquis* as well as any new UK statute law provisions that are aligned with EU laws coming into force after an effective Brexit. Divergences in interpretation and implementation could grow which would create further problems for

[10] The Prime Minister, Theresa May, speaking on 2 November 2015 at the Conservative Party Conference at The ICC, Birmingham, "*The good that Government can do"*.

[11] Ibid.

[12] Ibid.

[13] On establishing "equivalence" under certain important EU Regulations such as EMIR, see related article "*Brexit – Implications for the Derivatives Market*" in our September 2016 issue of Delta Report here: http://www.whitecase.com/publications/article/brexit-implications-derivatives-market.

the UK where it may be desirable to establish equivalence or maintain consistency for various reasons.

Potential involvement of the ECJ in the Brexit process

There is the possibility that the UK's departure from the EU could end up before the ECJ, in particular in relation to the revocability of Article 50. This is because the UK Supreme Court, as a final court of appeal, is required by EU treaties to refer to ECJ for a preliminary ruling on any question of interpretation of the Treaties, the answer to which is necessary for its judgment, unless there is no reasonable doubt as to the meaning of the specific EU law provision in question.[14]

One issue in relation to which a reference could be made in the present case is whether a notification to leave the EU under Article 50 could be unilaterally withdrawn, or revoked, after it is given, but before Brexit has taken effect. Lord Kerr of Kinlochard who has been credited with authorising the text of Article 50 said in an interview with the BBC[15] that the process of Article 50 is revocable. As a question of EU law this could require an authoritative interpretation by the ECJ.

The DC assumed in its judgment[16] that an Article 50 notification is irrevocable, but this was on the basis that the parties were agreed on this point. A reference could be made on this point in the event that the Supreme Court (or indeed a lower court following fresh legal action) decides it needs this question answered. It is worth noting that the Government's skeleton grounds for appeal do not mention irrevocability.[17]

Under Article 68 ("**Article 68**") of the *Vienna Convention on the Law of the Treaties* (the "**Vienna Convention**"), a notification of intention to withdraw from a treaty "may be revoked at any time before it takes effect".[18] This provision does not override any specific arrangements in a treaty, and treaties vary widely on this point.[19] The TEU is silent on this matter. The recently published House of Commons Library briefing paper on this very issue examined a number of different academic viewpoints but did not rule out the possibility of the ECJ making a determination on the revocability question, rather it says that the ECJ would interpret "purposively" and not according to academic opinions and might take account of the general principle of international law as set out in Article 68.[20] No specific conclusions were drawn in that paper.

If a notification can be reversed, this will be crucial for the political handling of Brexit during the negotiation process. It can also be argued that the ECJ's jurisdiction can extend to not only the process, but also content and implementation of exit terms with wide implications for rights of citizens, companies and institutions under EU treaties.[21]

In addition to the revocability issue, any withdrawal agreement between the UK and the EU may be subject to judicial review by the ECJ.[22] It has been argued that the European Council's decision to conclude the agreement could be challenged before the ECJ through an action for annulment (Article 263 TFEU).[23] Some

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[14] The "act eclair" doctrine as established in the case law of ECJ (largely in the judgment dated 6 October 198 2 in Case 283/81, Srl CILFIT and Lanificio di Gavardo SpA v Ministry of Health) and Article 267 of the *Treaty on the Functioning of the European Union* (TFEU).

[15] The BBC interview and article can be accessed here: http://www.bbc.co.uk/news/uk-scotland-scotland-politics-37852628

[16] Paragraph 10, judgment dated 3 November 2016 in *R (on the application of Miller & Dos Santos) v Secretary of State for Exiting the European Union* [2016] EWHC 2768 (Admin).

[17] Grounds of Appeal to the Supreme Court of the Secretary of State for Exiting the European Union.

[18] Vienna Convention on the law of treaties, concluded on 23 May 1969.

[19] Article 5 of the Vienna Convention. See also Laurence R Helfer, "Exiting Treaties", *Virginia Law Review,* Vol 91 (2005) 1579, 1597.

[20] House of Commons Briefing papers CBP-7763, as published on 14 November 2016, "*Brexit and the EU Court*".

[21] Koen Lenaerts, President of the ECJ, in an interview with Financial Times, said that the legal path for a country to leave the EU, "*can be interpreted by our court like any other provision of union law*" and he "*can't even start intellectually beginning, imagining how and where and from which angle it might come".* See *"'May ways' Brexit may go to EU courts, top ECJ judge says – Europe's most senior judge outlines potentially pivotal role in UK's departure"*, Financial Times, 21 November 2016.

[22] European Parliament briefing February 2016: "*Article 50 TEU: Withdrawal of a Member State from the EU*".

[23] Ibid.

have argued that the ECJ may be requested to opine on the draft withdrawal agreement on the issue of its compatibility with EU law (Article 218(11) TFEU), whereas others see this as impossible since Article 50 only refers to Article 218(3).[24]

In summary, it would seem that there are still many ways by which the Brexit question could end up in front of the ECJ.

Concluding Remarks on Timing

The European Commission's chief Brexit negotiator, Michel Barnier, during his first public speech on the issue since being appointed said that "*it is clear that actual [Brexit] negotiations will be shorter than two years*" because such period would include the time for the European Council to set guidelines and to authorise negotiations, approval of the negotiated deal by the Europe Council and the European Parliament, and finally UK's approval of the agreement[25]. This effectively sets an October 2018 deadline for completing the exit talks.

On the 7 December 2016, Theresa May won the backing of Members of Parliament for her March 2017 timetable after agreeing to set out UK's Brexit strategy before triggering Article 50. Government sources say that it is not an attempt to short-circuit the Supreme Court ruling on the issue. However, the Prime Minister's team argues that it will be hard for Members of Parliament to reserve their support come March if they have already voted for the timetable.

In a further speech on 17 January 2017, Theresa May outlined the 12 objectives of the UK Government's Brexit negotiation plan. Crucially, she confirmed that a final deal on Britain's exit from the EU will be put to a vote of both Houses of Parliament. However, no clarification was given by the Prime Minister when asked by the press what the implications on timing and Britain's then status in the EU would be should the Parliament vote to reject such a deal in due course.

We will continue to track developments of the Brexit topic and provide further updates on points of interest. Please also see our previous article in the Delta Report "Brexit: Implications for the Derivatives Market".

European Margin Rules for Non-cleared OTC Derivatives – The Margin Big Bang

Introduction

As we reported in our September 2016 issue of the Delta Report, the European Commission (the "**EC**") has been working towards an early 2017 phase-in commencement in respect of the rules for margining of OTC non-cleared derivatives (the "**Margin Rules**"). This has left Europe behind schedule as compared with the agreed phase-in timetable set out in the supranational BCBS-IOSCO framework and contrasts with the United States where the phase-in timetable for the rules of the Commodities Futures Trading Commission (the "**CFTC**") commenced on 1 September 2016 (as did regimes in Canada and Japan). On 4 October 2016, the EC adopted the draft regulatory standards submitted by the European Supervisory Authorities (the "**ESAs**") (the "**Final RTS**")[26]. The Final RTS were adopted with several amendments as compared with the draft submitted to the EC by the ESAs (the "**ESAs Draft RTS**")[27], (being the draft we commented on in our September issue of the Delta Report). The Final RTS have now been published in the Official Journal of the European Union and entered into force on 4 January 2017. From 4 February 2017, counterparties who each have a group aggregate average notional amount of EUR 3 trillion for non-cleared OTC derivatives[28] will have to begin posting both initial margin ("**IM**") and variation margin ("**VM**") (with a phase-in then commencing on

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[24] C M Rieder, '*The withdrawal clause of the Lisbon Treaty in the light of EU citizenship'.*

[25] Press conference by the European Commission on 6 December 2016 in Brussels as reported in all the major papers.

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

[27] http://www.eba.europa.eu/-/esas-publish-final-draft-technical-standards-on-margin-requirements-for-non-centrally-cleared-otc-derivatives

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

such date through to 1 September 2020). From 1 March 2017, there will be a market "big bang" bringing all FC's and NFC+'s[29] within scope of the obligation to post VM in accordance with the Margin Rules[30]. In this edition of the Delta Report, we look to summarise the changes made between the Final RTS and the ESAs Draft RTS, provide a snapshot of which market participants will need to comply with the rules and when and, finally, outline the tools and documentation available to market participants to comply with the new requirements.

Update

The Final RTS and the ESAs Draft RTS

The Final RTS adopted by the EC departed from the ESAs Draft RTS in a number of ways despite the ESAs preparing an opinion in September 2016 arguing against such changes being made[31]. As such, the position is now settled that:

(a) pension funds will be exempt from the "concentration limits" that apply to the posting of IM when the IM posted exceeds EUR 1 billion[32]. The EC's rationale for disapplying the diversification requirements to pension funds was that such funds would resort to using multiple counterparties which generated additional credit and foreign exchange risk for them. It was considered a disproportionate requirement considering the limited impact it would have in reducing systemic risk[33];

(b) the obligation to collect VM within the same business day has been amended to an obligation to post VM on the same business day[34]. The EC has commented that this change is consistent with the terminology used in the Financial Collateral Directive[35] and has been adopted in recognition of the fact that intra-day posting of margin simply isn't possible for a large number of market participants. It has also been stated by the EC that this clarifies the intention that margin can be deemed to be provided when the posting counterparty instructs their custodian (as opposed to when such margin arrives in the relevant custodial account for posting to their counterparty)[36];

(c) the 2.5% threshold in Article 31(2)(c) that applies where a counterparty faces an entity in a "non-netting" jurisdiction will only apply (a) where it is not possible to collect margin on a gross basis[37] and (b) to contracts entered into after the entry into force of the Final RTS. This is a significant departure from previous drafts of the Margin Rules which subjected all contracts concluded with counterparties in non-netting jurisdictions to the 2.5% limit (irrespective of whether margin could be collected on a gross basis) and appeared to imply that all contracts concluded prior to entry into force of the Final RTS would also be brought within scope;

(d) it is now clear that a counterparty looking to ascertain whether they exceed the threshold to post IM in 2017 will have to "look back" to 2016 (which was unclear in the ESAs Draft RTS);

(e) counterparties who belong to the same group will not have to exchange margin until their application for the exemption (the "**Intra-Group Exemption**") of such contracts has been decided upon by the

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

30 Such date is also applicable for the purposes of the CFTC in the United States.

31 https://www.eba.europa.eu/-/esas-reject-proposed-amendments-from-the-european-commission-to-technical-standards-on-non-centrally-cleared-otc-derivatives

32 The concentration limits are contained in Article 8(1) Final RTS and provide that certain collateral from a counterparty issued by a single issuer or a single group may not exceed the greater of 15% of the total collateral collected or €10 million. A 40% / €10 million requirement applies to securitisation tranches, convertible debt and equities.

33 Article 8(4) Final RTS provides that such entities must still establish procedures to monitor concentration risk with respect to the collateral types set out in (c) to (l) of Article 4(1) and take steps to diversify the pool if necessary.

34 Article 12(1) Final RTS.

35 http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32002L0047&from=EN

36 Comments by ECON Members on the ESAs' Opinion of 8 September 2016 on the amended draft RTS on risk-mitigation techniques for non-cleared derivatives of 28 July 2016.

37 Article 31 Final RTS. It is presently unclear when such situation would arise. This would seem to indicate something over and above not being able to obtain a clean netting and/or collateral opinion (perhaps the entity itself is restricted from posting collateral).

relevant competent authorities. The derogation (for both IM and VM) in respect of contracts that could potentially fall within the Intra-Group Exemption had been removed in the previous draft but this has now been restored[38]. The effect of this is to confirm that the obligation to post IM and VM will now apply to such contracts either in accordance with the relevant phase-in timetable (or 1 March 2017 in respect of VM) or 4 July 2017, whichever is the later; and

(f) that counterparties will not be required to exchange collateral with either NFC-s established in the EU or entities that would be NFC-s[39] were they established in the EU (i.e. they are a third country entity that would be below the clearing threshold). This has been clarified in the Final RTS after removal in a prior draft[40].

Snapshot – The Margin Rules

Who is affected?

Article 11(3) of EMIR requires FCs and NFC+s[41] 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.

Will the Margin Rules apply to third-country entities ("TCEs")?

Yes. Under Article 11(12) of EMIR, the collateral exchange requirements also apply to OTC derivative contracts entered into between TCEs that would be subject to the requirements of the Margin Rules if they were established in the EU where the contract has a direct, substantial and foreseeable effect within the EU[42] or such obligation is necessary or appropriate to prevent the evasion of any provision of EMIR. The Final RTS will only apply if neither counterparty to an OTC derivative contract is established in a third country whose legal supervisory and enforcement regime has been declared equivalent to EMIR[43]. In any case, there is expected to be pressure from an EU firm on a non-EU counterparty to post margin (even if the Margin Rules do not apply to them) to facilitate such EU firm's own compliance. This is illustrated further below.

Cross-border Categories

Margin Requirements Apply	**IM and VM requirements apply**
Margin Requirements Apply to EU firm	• IM and VM requirements apply to EU firm • May be pressure from EU firm on non-EU counterparty to comply to facilitate own compliance
Margin Requirements Apply if Qualifying Guarantee	• IM and VM requirements apply if at least one counterparty benefits from a Qualifying Guarantee from an FC
Margin Requirements Apply to EU firm Unless Complying With Equivalent Jurisdiction	• IM and VM requirements apply • Can be disapplied if parties comply with third country regime rather than EMIR (if such regime deemed equivalent)
Deemed Compliance	• IM and VM requirements do not apply

38 Article 38(2) Final RTS.

39 As defined in EMIR.

40 Article 24 Final RTS.

41 As defined in EMIR.

42 "**Direct, substantial and foreseeable effect**" means those contracts where at least one of the counterparties benefits from a guarantee provided by an FC where such guarantee exceeds an aggregate notional amount of €8 billion *and* is at least equal to 5% of the sum of current exposures of the FC established in the EU issuing the guarantee *or* where the two counterparties contract via their branches in the EU *and* would qualify as FCs if established in the EU.

43 Article 13 of EMIR provides that the EC may adopt "equivalence" decisions which declare that the arrangements of a third country (e.g. in respect of margining) are equivalent to those of the EU.

EMIR: Cross-Border – Equivalence

		EU Firm (including branches established in Third Countries)	Equivalent Third Country	
			EU Branch	Third Country Firm
EU Firm (including branches established in Third Countries)		Margin Requirements Apply	Margin Requirements Apply to EU firm Unless Complying With Equivalent Jurisdiction	
Non Equivalent Third Country	**EU Branch**	**Margin requirements Apply to EU firm**	Deemed Compliance	
	Third Country Firm			

EMIR: Cross-Border – Non-Equivalence

		EU Firm (including branches established in Third Countries)	Non-Equivalent Third Country	
			EU Branch	Third Country Firm
EU Firm (including branches established in Third Countries)		Margin Requirements Apply	**Margin Requirements Apply to EU firm**	
Non-Equivalent Third Country	**EU Branch**	**Margin requirements Apply to EU firm**	Margin Requirements Apply (FCs only)	**Margin Requirements Apply if Qualifying Guarantee**
	Third Country Firm		**Margin Requirements Apply if Qualifying Guarantee**	**Margin Requirements Apply if Qualifying Guarantee**

How will Brexit change this analysis for UK firms?

Following a British exit from the EU, UK entities who would be FCs or NFC+s transacting with either EU counterparties (if such counterparties are subject to the Margin Rules) or non-EU counterparties (if both parties are directly subject to the Margin Rules as described above for TCEs) would still be required to comply. If the UK were to become a TCE following a British exit from the EU, an equivalence decision under Article 13 of EMIR would be required in order to prevent counterparties to OTC derivative transactions from having to comply with two sets of rules (which may eventually not be consistent depending on how such legislation subsequently applies in the UK).

How do counterparties calculation margin with third country entities?

Where a counterparty is domiciled in a third country, the rules provide that counterparties may calculate margins for a netting set that includes (a) non-centrally cleared OTC derivatives subject to margin requirements under EMIR and (b) contracts that are both identified as non-centrally cleared OTC derivatives by the regulatory regime applicable to the TCE and subject to margin rules in the regulatory regime applicable to the TCE. The cap mentioned above in relation to counterparties in non-netting jurisdictions that applies where it is not possible to collect margin, even on a gross basis, should also be noted.

Are there any exemptions?

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[44]. Exemptions also apply for:

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

(b) intra-group transactions[45];

(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)[46];

(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[47]); and

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

When will I have to comply?

As mentioned in the introduction, the "Phase 1" effective date is 4 February 2017. The "VM for all counterparties" effective date will be 1 March 2017. The following phase-in will then apply in respect of the IM requirements of the Margin Rules:

Phase 2 **September 2017**	**IM:** If aggregate month-end notional amount in March, April and May 2017 is greater than €2.25* trillion
Phase 3 **September 2018**	**IM:** If aggregate month-end notional amount in March, April and May 2018 is greater than €1.5* trillion
Phase 4 **September 2019**	**IM:** If aggregate month-end notional amount in March, April and May 2019 is greater than €0.75* trillion
Phase 5 **September 2020**	**IM:** If aggregate month-end notional amount in March, April and May 2020 is greater than €8* billion. **End of phase-in.** * *All thresholds are on a group, consolidated basis*

44 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.

45 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*".

46 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. This is because the scope of what constitutes an FX forward is due to be defined in the amended Markets in Financial Instruments Directive and Regulation (MiFID II).

47 Recital (5) Final RTS.

How will I know if the rules apply to me?

The ISDA WGMR has worked to produce the ISDA Regulatory Margin Self-Disclosure Letter (the "**SDL**") which allows parties entering into trading documentation to identify and classify each counterparty to determine if and when the relevant margin regulations will be applicable to that trading relationship. The SDL will allow market participants to disclose the following information to each other:

(a) General information – e.g. LEI, legal name;

(b) entity status – Under applicable margin rules (e.g. "swap dealer" (CFTC rules) / "NFC+" etc.) and whether any exemptions are available;

(c) cross-border status – Under the applicable margin rules (e.g. "US Person", "Third-country entity (TCE)" etc.);

(d) notional thresholds – Whether relevant notional thresholds have been crossed in a particular year for the purposes of determining when the phase-in will apply to that trading relationship; and

(e) threshold tracking is required to be carried out on a group/ affiliate basis due to the aggregation requirements. Firms will therefore also need to provide information about their group structure (including provision of their ultimate parent's identifier).

The SDL is now available on ISDA Amend providing a central repository of information to determine if, and when, transactions will become subject to regulatory margin requirements.

ISDA 2016 Variation Margin Protocol

Has ISDA published a protocol to assist market participants with compliance?

The ISDA WGMR has also produced the ISDA 2016 Variation Margin Protocol (the "**Protocol**"). The Protocol provides for three different "methods" for creating new documentation (or amending existing documentation) and allows different versions of each method to be applied depending upon the applicable regime. The Protocol is a "questionnaire style" protocol and requires a party to submit an adherence letter to ISDA and exchange questionnaires to put into effect the substantive protocol terms as between the two adhering parties. Adherence constitutes a binding agreement between the parties to amend the agreements covered by the Protocol.

The Protocol has been designed to cover NY-law CSAs (security interest), English-law CSAs (title transfer) and Japanese law CSAs (all versions) along with both versions of the ISDA Master Agreement and non-ISDA Master Agreement framework agreements that attach an ISDA CSA. It currently covers regulatory regimes in the EU, United States, Switzerland, Canada and Japan.

The three "methods" by which parties may amend their existing credit support documentation to bring it into line with local regulatory requirements are as follows:

(a) **Amend Method**. Terms in existing CSAs are amended as necessary to comply with the regulatory requirements of the relevant jurisdictions. It requires an existing CSA(s) to be in place. Both legacy trades and new trades are covered under the amended CSA.

(b) **Replicate-and-Amend**. Little difference to the Amend Method other than the new CSA that is created does not cover legacy trades. For this Method though, the existing CSA remains in place but a second CSA (based on the terms of that existing CSA) is created and then amended to comply with the regulatory requirements of the relevant jurisdictions. It also requires an existing CSA(s) to be in place.

(c) **New CSA**. Parties enter into a new CSA with standard terms and certain optional terms that are generated through the Questionnaire. This method can also be used to put in place an ISDA where no existing ISDA has been entered into. This is also useful for where parties do not have an existing CSA in place.

Utility of the Protocol

The Protocol has sought to provide a go-to method for counterparties to comply with margin regulations on a

cross-border basis. However, the many compromises in the ISDA WGMR over (i) what needed to be a "Condition Precedent" to use of the Protocol; (ii) the scope of the "New CSA" method; and (iii) the scope of the Protocol itself have resulted in a product that may be challenging to implement.

The Protocol nevertheless does provide an administratively efficient method of making the necessary amendments to margining documentation. In the EU, with the rules just having been finalised, it is an effective "back-up" due to the time constraints.

It will likewise be useful for straightforward cash/ non-cash collateral CSAs where the Amend-and-Replicate Method can readily be used and there are limited product types being added to a netting set. Furthermore, for situations where the original CSA is non-bespoke, there is only one CSA under a Master Agreement and there is likely to be agreement over the "Method" to be used between counterparties (e.g. it is acknowledged that legacy transactions will remain under an existing CSA), there are few limitations in using the Protocol.

However, certain drawbacks are clear, namely:

(a) In situations where IM will need to be provided in any case (as there is no Protocol for IM), it is likely that simultaneous bilateral discussions will take place. As such, it may be more efficient to simply agree the documentation outside of the Protocol.

(b) Those adopting the VM Protocol will have to read three documents together (the original document, the exchanged questionnaires and the relevant exhibit) in order to make sense of the commercial agreement.

(c) No final document is produced via Protocol (although ISDA is working on this functionality being available in ISDA Amend).

(d) While 349 market participants have adhered as of the date of publication, it may be the case for some that this is to ensure a fall-back is in place if bilateral do not complete by the deadline.

(e) Parties will have to familiarise themselves not only with collateral documentation but the Protocol operation – such complexity has never been tested via the Protocol method.

(f) The Protocol cannot be used by counterparties with more than one CSA under a Master Agreement.

(g) Where using the Amend/ Amend-and-Replicate Method:

    (i) Parties wishing to deviate from the regulatory minimums (e.g. to impose larger haircuts/ credit assessment provisions) are unable to do so.

    (ii) The Independent Amount (e.g. where no IM) is automatically set to zero by default if not "matched" correctly.

(h) Where using the New CSA Method:

    (i) It is restrictive in terms of what types of collateral can be posted (for example it does not allow asset-backed securities, some of which are permitted under the EU Rules).

    (ii) EU counterparties cannot post cash that is not in a "Major Currency".

    (iii) The overlay with existing Protocols. Where parties have previously agreed to apply negative interest rate provisions (either directly in their documentation or through adherence to the ISDA 2014 Collateral Negative Interest Protocol) then the "Negative Interest" election within the New CSA created via the Protocol will be applicable.

    (iv) Any election of the parties to add additional currencies or sovereign debt securities is only effective if the "Collateral Expansion Condition" is satisfied i.e. if the answers of both parties to the question "Consent to Substitution Required?" are the same.

    (v) The underlying ISDA Master Agreement must be considered (e.g. under the "New CSA" Method, the Base Currency will be the Termination Currency under the accompanying master agreement but subject to a raft of conditions including a "Matching" exercise).

New standard form documentation

Assuming use of the Protocol is not practical, 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.

Both standard form VM and IM documentation has been developed by ISDA through the WGMR. The general approach to this new documentation has been to update existing documentation for compliance with global margin rules in key jurisdictions. Given the time constraints, the documentation does, however, remain in similar form to precedents with adjustments only made for the Margin Rules. The new documentation includes:

(a) 2016 New York Law VM CSA and English Law VM CSA (each with recommended provisions for Japanese counterparties);

(b) 2016 New York Law VM CSA and English Law VM CSA with allowance for an Independent Amount (i.e. unregulated IM);

(c) 2016 Japanese law VM CSA;

(d) 2016 New York Law "Phase One" IM CSA (and recommended provisions for Japanese collateral);

(e) 2016 English Law "Phase One" IM CSD;

(f) 2016 Japanese Law "Phase One" IM CSA and Trust Scheme Addendum to the Japanese Law IM CSA;

(g) Euroclear Security Agreement and Collateral Transfer Agreement (and recommended provisions for Japanese collateral); and

(h) Clearstream Security Agreement and Collateral Transfer Agreement.

Will I need to bring existing transactions under my new margin documentation?

The Margin Rules only apply to new contracts entered into after the relevant phase-in dates, although this will catch new transactions under a pre-existing master netting set. Parties may choose to include legacy transactions as "Covered Transactions" all under one VM CSA or run this CSA side-by-side with an existing CSA. This will depend on a counterparty's view of whether it is economic and/or operationally practical to move the transactions over. However, there can be no "cherry-picking" of transactions; it is an all or nothing approach in that once one legacy transaction moves over, all existing transactions move over. As described above, the Protocol provides different optionality for parties in this respect depending on whether counterparties wish to retain their existing collateral documentation terms for legacy transactions or, bring them all under one.

Conclusion

The Margin Rules represent the final plank of the post-crisis regulatory framework for derivatives. Although a number of market participants had existing collateral documentation in place, the mandatory requirements and minimum standards agreed at supranational level in 2011 indicated that this would represent a huge deviation from the then current market practice. With the deadline of 1 March 2017 now under three months away, market participants should carefully examine whether they fall within the scope of the Margin Rules (both in Europe and in other applicable jurisdictions) and ascertain the documentation and/or amendments to existing documentation that will be required for compliance.

Key Issues for Derivative Transactions under the BRRD

Scope

The Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the

recovery and resolution of credit institutions and investment firms ("**BRRD**")[48] introduced an EU-wide regime for recovery and resolution planning in respect of BRRD Entities (as defined below). Prior to the BRRD, there was no harmonisation of the procedures for resolving such institutions at the EU level. Resolution authorities are the authorities designated by each member state to exercise the powers, functions and tools laid out in the BRRD.

BRRD Entity	(a) credit institutions and investment firms that are established in the EU.
	(b) financial institutions that are established in the EU when the institution is a subsidiary[49] of a credit institution or investment firm (or of a company referred to in (c) and (d) below) and is covered by the supervision of the parent undertaking on a consolidated basis.
	(c) financial holding companies, mixed financial holding companies and mixed-activity holding companies that are established in the EU.
	(d) parent financial holding companies in a Member State[50], EU parent financial holding companies[51], parent mixed financial holding companies in a Member State, EU parent mixed financial holding companies.
	(e) EU branches of institutions that are established outside the EU in accordance with specific conditions laid out in the BRRD[52].

What are the four main resolution tools that a resolution authority may use?

Resolution authorities can apply the resolution tools individually or in any combination although the asset separation tool can only be used together with another resolution tool. The use of resolution tools and powers provided in the BRRD will replace senior management and disrupt the rights of shareholders and creditors.

Four resolution tools that a resolution authority may apply:	Sale of business	Sale of all or part of business without shareholder consent.
	Bridge institution	Transfer of all or part of the business to an entity wholly or partially owned by the public authorities.
	Asset separation	Transfer of 'bad' assets to a separate vehicle or 'bad bank'
	Bail-in	Write down of equity debt

48 Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=en

49 Non-EU subsidiaries of EU companies will not be in scope.

50 Pursuant to point (30) of Article 4(1) of Regulation (EU) 575/2017 this means: a parent financial company in a Member State: a financial holding company which is not itself a subsidiary of an institution authorised in the same Member State, or of a financial holding company or mixed financial holding company set up in the same Member State.

51 Pursuant to point (31) of Article 4(1) of Regulation (EU) 575/2017 this means: a parent financial holding company in a Member State which is not a subsidiary of an institution authorised in any Member State or of another financial holding company or mixed financial holding company set up in any Member State.

52 Article 1 defines the scope of the BRRD as including "*branches of institutions that are established outside the Union in accordance with the specific conditions laid down in this Directive*" (EU branches).
The requirement as to the actions that a resolution authority should be able to take as regards these branches is defined in a broad manner. Articles 94(4)(a) (i) and (ii) of the BRRD request that EU Member States equip their authorities with powers to enforce third country resolution proceedings by being able to exercise resolution tools over, respectively, assets of a third country institution or parent undertaking that is located in their jurisdiction or governed by the law of that Member State and rights or liabilities of a third-country institution that are booked by the EU branch in their Member State or governed by the law of their Member State, or where claims in relation to such rights and liabilities are enforceable in their Member State. For EU branches that are *not* subject to third-country resolution proceedings (or where the third-country resolution proceeding cannot be recognised), Article 96(3) applies, which sets out principles and requirements that the authority should have regard to when taking action (in so far as they are relevant).

What is bail-in?

Bail-in is a process that may be utilised for either:	
internal recapitalisation that may be triggered when a firm reaches the point of non-viability if the relevant resolution authority forms the view that the entity can be restored to solvency or long term viability; or	conversion to equity or reduction of the principal amount of claims or debt instruments that are transferred to a bridge institution (with a view to providing capital for that bridge institution) or through the sale of business tool or the asset separation tool.

Resolution authorities may only apply the bail-in tool for recapitalisation purposes if there is a reasonable prospect that the application of that tool will restore the relevant BRRD Entity to financial soundness and long-term viability.

Losses are imposed on certain of a firm's direct stakeholders according to a defined hierarchy (pursuant to Article 48 of the BRRD) by a process of "bailing-in", either by writing down their claims or by converting them to equity. The aim of a bail-in is that shareholders and creditors of the failing institution bear an appropriate part of losses arising from the failure of the institution. Bail-in may be applied to all liabilities of an institution (except certain excluded ones).

Which powers of a resolution authority may affect a derivative transaction?

Under the BRRD, resolution authorities have an extremely broad range of powers which can directly impact existing derivative transactions.

Powers that may impact derivative transactions	Article BRRD
If a resolution authority exercises its right to close-out, in the case that the non-defaulting counterparty does not enter into replacement trades, that counterparty would lose their hedges	63(1)(k))
The close-out amount may be calculated by the resolution authority	49(4)
Rights, assets or liabilities of an entity under resolution may be transferred to another entity, with the consent of that entity	63(1)(d)
Terms of contracts can be cancelled or modified in order to cancel, reduce or defer liabilities	64(1)(f)
Certain contractual terms (i.e. termination/enforcement rights) may be excluded	68
Counterparties' rights to terminate may be temporarily suspended	71
Counterparties' rights to enforce security may be temporarily suspended	70
Counterparties' payment and delivery obligations may be temporarily suspended	69
EU branches may also be subject to resolution	96

It is worth pointing out that in the context of a major restructuring, a resolution authority may decide to go far beyond its statutory powers or interpret them in a very broad fashion. The BRRD has not been put into practice yet and therefore the ultimate practical consequences remain unknown.

Contractual recognition under Article 55 and its scope

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

Article 55 – Which liabilities are included?	not excluded under Article 44(2)
	not a deposit
	governed by the law of a third country
	issued or entered into after the date on which a Member State transposes into national law the provisions of the BRRD (1 January 2016 at the latest or earlier)

Non-EU incorporated firms and their EU branches are out of scope for the purposes of Article 55. In respect of "*excluded liabilities*" please see further discussion below.

The contractual recognition requirement will not apply where the resolution authority determines that the law of a third country or a binding agreement concluded with that third country allows the resolution authority to exercise its write down or conversion powers.

Can the contractual obligation under Article 55 be disapplied in respect of third country agreements?

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

Article 55 contemplates also those situations where an institution fails to include the Article 55 contractual provisions, in which case such failure will not prevent the resolution authority from exercising the write down and conversion powers in relation to that liability.

Separately, at the UK level, on 25 November 2015, the Prudential Regulatory Authority ("**PRA**") published a modification by consent[53] which disapplies Contractual Recognition of Bail-In Rules 1.2 and 2.1[54] in circumstances where compliance with them in respect of an unsecured liability that is not a debt instrument is impracticable. The PRA expects BRRD Entities to make their own reasoned assessment with regard to impracticability in relation to an unsecured liability that is not a debt instrument.

The exceptions that the PRA may consider include but are not limited to	
Not permitted	Relevant third-country authorities have informed the BRRD Entity in writing they will not allow it to include contractual recognition language in agreements or instruments creating liabilities governed by the law of that third country
Illegality	It is illegal in the third country for the BRRD Entity to include contractual recognition language in agreements or instruments creating liabilities governed by the laws of that third country
Impossibility	The creation of liabilities is governed by international protocols which the BRRD Entity has in practice no power to amend

53 Available at: http://www.bankofengland.co.uk/pra/Documents/publications/cp/2016/cp816.pdf

54 Available at: http://www.prarulebook.co.uk/rulebook/Content/Part/211722/05-01-2017#211722

The exceptions that the PRA may consider include but are not limited to	
Impracticability	Contractual terms are imposed on the BRRD Entity by virtue of its membership and participation terms in non-EU bodies, whose use is necessarily on standard terms for all members and impracticable to amend bilaterally
Contingency	The liability which would be subject to the contractual recognition requirement is contingent on a breach of the contract

It is clear that the above "exceptions" are of legal nature so entities will unlikely be able to rely on any "impracticalities" of "operational" nature. In addition, the PRA has confirmed that it does not consider loss of competitiveness or profitability to be grounds for an impracticability judgement.

Which instruments, contracts or products are covered by the bail-in tool?

The BRRD is a piece of legislation that lays down rules and procedures relating to the recovery and resolution of financial entities such that the scope of powers given to resolution authorities is extremely broad as they have to deal with significant liabilities that arise from numerous and often complex contracts. The relevant concept is therefore not expressed in terms of products or contracts but rights and liabilities.

Article 44(1) of the BRRD, which describes the scope of bail-in, clearly states that it applies to "*all liabilities*" which are not excluded. Capital instruments, bonds and other instruments creating indebtedness, fall within the scope.

The BRRD does not provide a list of contracts that are impacted but gives resolution authorities general and ancillary powers to apply the resolution tools. These powers can impact directly on products and contracts.

What constitutes secured liabilities?

Article 44(2)(b) of the BRRD excludes "secured liabilities including covered bonds and liabilities in the form of financial instruments used for hedging purposes which form an integral part of the cover pool and which according to national law are secured in a way similar to covered bonds".

The actual meaning of "secured liability" is clarified in Article 1(67) of the BRRD which defines it as "a liability where the right of the creditor to payment or other form of performance is secured by a charge, pledge or lien, or *collateral arrangements* including liabilities arising from repurchase transactions and other title transfer collateral arrangements".

Which conditions are necessary to qualify as a secured liability?

It is important to highlight that pursuant to Article 43(1) of the Commission Delegated Regulation (EU) 2016/1075 ("**Contractual Recognition RTS**")[55], for the purposes of Article 55, a secured liability *will not be considered as an excluded liability* where, at the time at which it is created, it is:

(a) not fully secured;

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

It is should be pointed out that there is no legal definition of what exactly constitutes "fully secured" and "fully collateralised on a continuous basis". We are of the opinion that provided there is a security or title transfer collateral arrangement under which collateral has been posted or delivered as of the date of entering into the relevant contract and remains outstanding and provided further that appropriate enforcement legal opinions (e.g. the ISDA collateral and netting opinions) have been issued, derivative transactions should be "*secured liabilities*".

As explained above, the relevant liabilities will have to comply with the requirements laid out in Article 43(2) of

[55] Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1075&from=EN

the Contractual Recognition RTS (and the relevant implementation rules of each Member State).

It is important to note that even though derivative liabilities may fall under the general exclusions from the scope of the bail-in power under Article 44(2) this will apply only to the extent that the value of the liability does not exceed the value of the collateral.[56]

At the UK level and in light of the Contractual Recognition RTS, the PRA has clarified the concept of "*unsecured liability*" and "*fully secured liability*" as follows:

"unsecured liability"	**"fully secured liability"**
in respect of liabilities created on or before 31 July 2016, a liability under which the right of the creditor to payment or other form of performance is not (i) secured by a charge, pledge, lien or mortgage, or (ii) subject to other collateral arrangements, including liabilities arising from repurchase transactions and other title transfer collateral arrangements; and in respect of liabilities created after 31 July 2016, a liability that is not a fully secured liability	a liability which, at the time it is created, is fully secured and governed by contractual terms that oblige the debtor to maintain the liability fully collateralised on a continuous basis in compliance with regulatory requirements of EU law[57] or of the law of a third country achieving effects that can be deemed equivalent to EU law

Can liabilities be excluded on exceptional circumstances?

Article 44(3) of the Contractual Recognition RTS permits the resolution authority to exclude liabilities, including those in respect of derivatives, from bail-in in exceptional circumstances where:

(a) it is not possible to bail-in that liability within a reasonable time;

(b) the exclusion is strictly necessary to ensure the continuity of critical functions and core business of the entity;

(c) the exclusion is strictly necessary to avoid giving rise to widespread contagion; and

(d) the application of the bail-in to those liabilities would cause a destruction in value such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in.

How are derivatives valued in the context of a bail-in?

In the case that the resolution authority exercises its right to close-out a contract which has not already been terminated by the counterparty, the counterparty is entitled to submit evidence of an actual transaction on economic terms equivalent to the closed-out transaction entered into on or after the close-out date of such transaction to re-establish on a net risk exposure basis, any hedge or related trading position that was constituted by the closed-out transaction. The valuation process is set out in the Commission Delegated Regulation (EU) 2016/1401 (the "**Valuation RTS**")[58].

The valuer will evaluate the proposed replacements trades to ensure they are commercially reasonable. If it concludes that the criteria are satisfied, it will determine the close-out amount at the price of those replacement trades.

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56 This could arise in a situation where the collateral held by a counterparty does not fully cover its exposure (e.g. due to a threshold amount in the documentation or the time gap in between the last margin call and close-out occurring). However, this would not make the entire claim subject to bail-in; only the difference between the collateral value and the sum due on close-out would not constitute an "excluded liability".

57 Article 11(3) of Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories ("**EMIR**") sets out the general obligation. EMIR margin requirements are developed more specifically by the Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty. Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&from=EN

58 Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R1401&from=EN

This approach is similar in some ways to the 1992 ISDA Master Agreement (Multicurrency – Cross-Border) market quotation methodology although actual executed transactions instead of quotations are required.

The Valuation RTS defines a "*commercially reasonable replacement trade*" as 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. Therefore, the notion of "commercially reasonable replacement trade" is broadly defined in order to enable the valuer to conduct the required assessment in all market contexts.[59]

What happens if no replacement trades are submitted?

If a valuer determines that the replacement trades submitted were not concluded on commercially reasonably terms or if a counterparty has not provided evidence of any replacement trades within the deadline set in the communication, the valuer will determine the close-out amount on the basis of the following:

(a) the mid-market end-of-day prices in line with the business-as-usual processes within the institution under resolution at the date determined pursuant to Article 8 of the Valuation RTS;

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

(c) adjustments to the prices and spreads mentioned in points (i) and (ii) where necessary to reflect the liquidity of the market for the underlying risks or instruments and the size.

On what date can the valuer rely to make its valuation?

For determining a value of the close-out amount, the valuer may consider a full range of available and reliable data sources. It may rely on observable market data or theoretical prices generated by valuation models aimed at estimating values, including the following sources of data:

(a) data provided by third parties, such as observable market data or valuation parameters data and quotes from market-makers or, where a contract is centrally cleared, values or estimates obtained from central counterparties;

(b) for standardised products, valuations generated by the valuer's own systems;

(c) data available within the institution under resolution, such as internal models and valuations;

(d) data provided by counterparties other than evidence of replacement trades communicated pursuant to the Valuation RTS, including data on current or previous valuation disputes with regard to similar or related transactions and quotes; and

(e) any other relevant data.

The Lehman Administration Surplus and the High Court Ruling in Waterfall IIC

Rule 2.88 Insolvency Rule 1986 — Interest

(A1) In this Rule, "the relevant date" means the date on which the company entered administration or, if the administration was immediately preceded by a winding up, the date on which the company went into liquidation.

(1) Where a debt proved in the administration bears interest, that interest is provable as part of the debt except in so far as it is payable in respect of any period after the relevant date.

(2) In the following circumstances the creditor's claim may include interest on the debt for periods before the relevant date, although not previously reserved or agreed.

(3) If the debt is due by virtue of a written instrument and payable at a certain time, interest may be claimed for the period from that time to the relevant date.

[59] Note that the obligation will be on the counterparty to actually replace the trade. The valuation process simply looks to provide compensation for doing so.

(4) If the debt is due otherwise, interest may only be claimed if, before the relevant date, a demand for payment of the debt was made in writing by or on behalf of the creditor, and notice given that interest would be payable from the date of the demand to the date of payment.

(5) Interest under paragraph (4) may only be claimed for the period from the date of the demand to the relevant date and for all the purposes of the Act and the Rules shall be chargeable at a rate not exceeding that mentioned in paragraph (6).

(6) The rate of interest to be claimed under paragraphs (3) and (4) is the rate specified in section 17 of the Judgments Act 1838 on the relevant date.

(7) Any surplus remaining after payment of the debts proved shall, before being applied for any purpose, be applied in paying interest on those debts in respect of the periods during which they have been outstanding since the relevant date.

(8) All interest payable under paragraph (7) ranks equally whether or not the debts on which it is payable rank equally.

(9) The rate of interest payable under paragraph (7) is whichever is the greater of the rate specified under paragraph (6) and the rate applicable to the debt apart from the administration.

Introduction

The High Court of Justice Chancery Division Companies Court in October 2016 delivered a judgment in the case of **Lehman Brothers International (Europe) (In Administration), Re.** ("**Waterfall IIC**"[60]). This is the third tranche of what has become known as the *Waterfall II* case which concerns the application of statutory interest pursuant to rule 2.88 of the Insolvency Rule 1986 ("**Rule 2.88**") on debts proved in the administration of Lehman Brothers International Europe ("**LBIE**"). Waterfall IIC deals with the particular issue of the construction and effect of pre-administration agreements in various standard form master agreements governed variously by English, New York or German law on the terms of which LBIE and its claimant counterparties undertook derivatives transactions before LBIE's insolvency. These agreements contain (amongst other things) provisions entitling a counterparty of a defaulting party (such as LBIE) to interest on amounts payable under the relevant agreements.

The principal question to be addressed in *Waterfall IIC* is whether under the 1992 (Multicurrency – Cross Border) and the 2002 ISDA Master Agreements (the "**ISDA Master Agreements**") and the German Master Agreement for Financial Derivatives Transactions (the "**German Master Agreement**"), LBIE's counterparty creditor is entitled to interest at a "*rate applicable to the debt apart from the administration*" within the meaning of Rule 2.88(9) which exceeds the rate of interest otherwise payable under Rule 2.88(7). The latter is the rate specified in section 17 of the Judgments Act 1838 (the "**Judgments Act Rate**"). Rule 2.88(9) provides for statutory interest under Rule 2.88(7) to be payable at the greater of: (a) the Judgments Act Rate on the date when the company entered administration and (b) the "*rate applicable to the debt apart from the administration*".

Key Ruling

The "Default Rate" is defined in the ISDA Master Agreements as "a rate per annum equal to the cost (without proof or evidence of any actual cost) to the relevant payee (as certified by it) if it were to fund or of funding the relevant amount plus 1% per annum."

1. "cost of funding"

It was held in *Waterfall IIC* that the "cost of funding" should be certified by reference to the cost which the relevant payee is or would be required to pay in borrowing the relevant amount under a loan transaction, whether actual or hypothetical, and "cost" means the price required to be paid in return for borrowing the funds over the period they are required. Other costs and losses, such as (a) the cost of equity funding; (b) the cost of funding the relevant payee's assets; (c) the costs associated with carrying a defaulted LBIE receivable on the balance sheet; (d) the actual or asserted cost to the relevant payee of funding a claim against LBIE; or (e) any other financial detriment or consequential loss, are not included. A hybrid means of funding could be included on the condition that it was possible to segregate the interest rate element from the funding cost of another nature. The relevant payee's certification was conclusive as to its cost of funding, save if irrational or in the case of bad faith or manifest numerical or mathematical error. This could be calculated in light of hindsight, by reference to relevant circumstances, or on a fluctuating basis taking into account relevant market conditions and other relevant facts or circumstances.

[60] [2016] EWHC 2417 (Ch).

2. “relevant payee”

A second key aspect of the ruling was in relation to the definition of “*relevant payee*” on the true construction of the term “*Default Rate*”. It was held that “*relevant payee*” referred only to LBIE’s original contractual counterparty and did not extend to a third party to whom LBIE’s counterparty has since transferred or assigned under Section 7 of the relevant ISDA Master Agreement its interest in any amount payable to it under Section 6(e) of the relevant ISDA Master Agreement. Justice Hildyard notes:

> It turns on whether section 7 of the relevant ISDA Master Agreement permits and enables the transfer of a bundle of rights exercisable by and to be calculated according to the position of the transferee, or (more restrictively) only such rights as the transferor had calculated according to that transferor’s position …[61]
>
> The better conclusion is that section 7, in both versions of the [ISDA] Master Agreements, restricted the right of transfer to the amounts which had become payable and would become payable to the transferor as at the time immediately before the transfer, in each case measured according to the position of the transferor. Put figuratively, the transferee is entitled to the tree planted by the transferor and such fruit as had grown and would grow on it when transferred, and not to the trust of a different variety or quantity which might have grown had the transferee planted the tree.[62]
>
> The wording in each of the versions [of the ISDA Master Agreements] … more naturally refers to amounts receivable as distinct from rights exercisable, and confines that which can be transferred to amounts which would have been payable to the transferor … the transferee cannot usually recover more than the transferor could have recovered.[63]

What is also clear from the court’s language above is that the *Default Rate* continues to run after the point of transfer or assignment provided that the transferee would be entitled to claim the relevant amount any *Default* Rate applicable to such amount provided that the interest is calculated based on what the transferor could have claimed based on the *transferor’s* cost *of borrowing*, *not* interest based on the transferee’s *own* costs.

3. Date of administration

The words "*the rate applicable to the debt apart from the administration*" in Rule 2.88(9) include, in the case of a provable debt that is a close-out sum under a contract, a contractual rate of interest that began to accrue only after the close-out sum became due and payable because of action taken by the creditor after the date of administration. If a creditor had contractual rights, whether actual or contingent, which were in existence at the date of administration and those rights included a right to a particular rate of interest, then when such right was exercised, that was the rate applicable for the purposes of Rule 2.88(9). This was the case whether or not the contractual right could be described as having "accrued" before the date of administration.

4. Others

Interpretation of agreements would largely be the same under New York law. The Court also determined issues concerning (a) creditors’ entitlement to compensation following automatic termination of the German Master Agreement; and (b) the effect of assigning compensation entitlement to a third party.

Waterfall I, Waterfall IIA and IIB issues

Waterfall I[64] is on its way to the Supreme Court. It was held at first instance and at the appeal level, that the surplus was to be distributed in the order of, first, statutory interest payable under Rule 2.88; secondly, non-provable claims of creditors, including claims to currency exchange losses resulting from a depreciation of sterling against the currency in which creditors’ claims were payable between the commencement of the administration and the date on which dividends were paid on such claims; and thirdly, to the payment of some US$2.27 billion subordinated debt.

Waterfall II consists of three separate hearings for the three separate issues. The first part (*Waterfall IIA*[65]) examined the entitlement of creditors to interest on their debts for periods after commencement of the

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[61] Ibid [259].

[62] Ibid [261].

[63] Ibid [262].

[64] Reported in [2014] EWHC 704 (Ch); [2015] Ch 1; [2015] EWCA Civ 485.

[65] [2015] EWHC 2269 (Ch)

administration of LBIE. It was held by the High Court that statutory interest pursuant to Rule 2.88 accrues on all debts, including contingent and future debts, from the commencement of the administration and ceases to accrue after payment of the final dividend. The second part (*Waterfall IIB*[66]) is not of substantial relevance to *Waterfall IIC* but concerns the construction and effect of various agreements made since the commencement of the administration between LBIE acting by the administrators and very significant numbers of its creditors.

"Possession or control" of Financial Collateral – Matter Number C-156/15

The Court of Justice of the European Union ("**CJEU**") has given its first ever ruling on the question of what constitutes "possession or control" of financial collateral for the purposes of the Financial Collateral Directive - Directive 2002/47 ("**FCD**").

The brief facts were that a depositor had placed monies with a bank. The account documentation contained the following provision:

> The Customer's monies in the Account, present and future, shall be pledged to the Bank as financial collateral and shall cover all debts owed by the Customer to the Bank. In the event that the Customer fails to provide the monies necessary to make the payments in the current account, or in any other situation in which, pursuant to the present contract or any other contracts entered into with the Bank, or on any other legal basis, a debt owed by the Customer to the Bank arises, the Bank shall be entitled to settle that debt by enforcing the financial collateral arrangement, that is to say, the Bank shall be entitled, without giving prior notice to the Customer, to debit (transfer) from the Account the amount owed.

The customer became insolvent and the bank debited the account for certain fees that had accrued prior to the onset of insolvency. The administrator of the customer sought to recover such fees. In proceedings in Latvia, the local courts were unsure as to: (i) the application of the FCD to ordinary bank accounts; and (ii) whether the priority given to holders of financial collateral was compatible with the general principles of *pari passu* treatment of creditors in insolvency. Accordingly, the Supreme Court of Latvia referred, *inter alia*, such questions to the CJEU for preliminary ruling. In response to those questions, the CJEU held:

> Directive 2002/47 on financial collateral arrangements is to be interpreted as conferring on the taker of financial collateral, such as the collateral at issue in the main proceedings, whereby monies deposited in a bank account are pledged to the bank to cover all the account holder's debts to the bank, the right to enforce the collateral, notwithstanding the commencement of insolvency proceedings in respect of the collateral provider, only if, first, the monies covered by the collateral were deposited in the account in question before the commencement of those proceedings or those monies were deposited on the day of commencement, the bank having proved that it was not aware, nor should have been aware, that those proceedings had commenced and, second, the account holder was prevented from disposing of those monies after they had been deposited in that account.

The CJEU has made clear that the FCD protections in relation to "after-acquired" collateral will not be available in circumstances where the collateral was acquired after the onset of insolvency. However, the position in relation to pre-existing security interests which attach to after-acquired property is unclear. As regards the requirement for the collateral taker to have taken possession or control of the collateral, the CJEU decision does not add much to existing case law. Unfortunately, the CJEU did not provide any guidance as to what a clause preventing dispossession should look like. The view of the Attorney General is slightly more illuminating:

> In the case of collateral provided in the form of cash deposited in an account, being in the control of the collateral taker must mean that the collateral taker not only has practical control over the account to which the collateral relates, but also has the right to prevent withdrawal of cash by the collateral taker in so far as is necessary to guarantee the relevant obligations ... Article 2(2) of [the FCD] must be interpreted to the effect that the provision of financial collateral in the form of cash deposited in a bank account requires the existence of a contractual clause conferring on the collateral taker the right to limit the use of monies deposited in that account in so far as is necessary to guarantee the relevant obligations.

[66] [2015] EWHC 2270 (Ch)

New German Insolvency Code Amends Legal Basis for Contractual Close-out Netting

Legal Background of the Law

The new law is – in its entirety – a reaction to the decision of the Federal Court of Justice dated 9 June 2016 (IX ZR 314/14). The decision has found netting provisions used throughout the financial industry, for example in the German Master Agreement for Financial Derivatives Transactions and the ISDA Master Agreement, to be invalid and thus confirmed doubts on the validity of such netting arrangements previously expressed by few legal authors, but generally perceived to be valid and thus coming as a surprise to many in the financial services industry.

The Federal Court of Justice held that contractual provisions on netting arrangements in a financial contract are invalid if they deviate from the mandatory provisions set out in Section 104 of the German Insolvency Code (*Insolvenzordnung* – "**InsO**"). Particularly the contractual calculation method for claims of non-performance in the case of insolvency by either party was declared invalid. Furthermore, the Federal Court of Justice decision left open whether a contractually agreed early termination right of a transaction may still be valid or whether this is an inadmissible deviation from Section 104 (1) and (2) InsO, which determines the opening of insolvency proceedings to be the relevant termination date.

On the same day that the Federal Court of Justice's decision was published, the German Federal Financial Supervisory Authority published a general decree seeking to diminish the potential legal impacts of the Federal Court of Justice's decision and the resulting uncertainty among market participants. The BaFin-Decree was limited in time and has automatically ceased to be effective on 31 December 2016.

The InsO Reform

A legislative reaction to the judgement was thus required to re-establish legal certainty for netting arrangements in the scope of German insolvency law. The new law amending the Insolvency Code was published in the Federal Gazette on 28 December 2016 and focuses on a revision of Sec. 104 InsO.

The revised version of Section 104 InsO now comprises five paragraphs instead of three. Thus, the structure of Sec. 104 InsO has been clarified and clearly differentiates between the statutory resolution mechanism for financial contracts in paragraphs 1 and 2 and the scope of possibilities to contractually amend the statutory concept in paragraphs 3 and 4. Paragraph 5 is a repetition of the former Sec. 104 para 3 sentence 3, which stipulates that the claim for non-performance by the contractual partner of the insolvent debtor can merely be asserted as an insolvency creditor.

Statutory Model for Automatic Resolution

The statutory model for resolving/settling financial contracts in case of insolvency remains conceptually unchanged. If the parties had agreed that delivery of goods with a market or stock exchange price or financial transactions are to take place on a fixed date or within a fixed period and if such date or expiry of the period occurs after the insolvency proceedings were opened, performance may not be claimed. However, claims for non-performance may still be made. A claim for non-performance shall cover the difference between the agreed price and the market or stock exchange price prevailing at a point in time agreed by the parties, at the latest, however, on the fifth working day after the opening of the insolvency proceedings at the place of performance for a contract with the agreed period of performance. If the parties do not enter into such an agreement, the second working day after the opening of the insolvency proceedings shall be the relevant date. The other party may bring such claim only as an insolvency creditor.

The list of financial transactions included in the statutory concept for settling such financial transactions was updated to reflect the current status of financial services supervision. The list of financial transactions included in the scope of Sec. 104 InsO is now defined with reference to annex I section C of directive 2014/65/EU (MiFID). However, this update does not materially affect the prior list, which was considered to be non-exhaustive in any case.

Possibilities to Deviate from the Statutory Model

The core of the reform is the new paragraph 4 of Section 104 InsO, which stipulates that counterparties may contractually agree on netting provisions that deviate from the statutory mechanism of termination and settlement of contracts regulated in Art. 104 InsO as long as these provisions are compatible with the

essential principles of Sec. 104 InsO (*vereinbar mit wesentlichen Grundgedanken*), a methodology frequently used for testing the validity of general terms and conditions under German law (see Section 307 para. 2 no 1 German Civil Code – BGB). The German legislator's explanation of this test is that the provision may not contradict the purpose of the statutory termination and settlement mechanism. Pursuant to the official reasoning (Official Record – BT-Drucks. 18/9983, 9), the purpose of the statutory mechanism is to protect the counterparty of the insolvent party from the insecurity which would result from the right, the administrator is normally granted to choose performance or non-performance of the contract and would otherwise allow the administrator to speculate on price movements. This purpose allows parties to contractually agree on i) the details of the termination of the contracts, ii) the calculation of the claims for non-performance and iii) the netting arrangements. The new Section 104 para. 4 sentence 2 illustrates the ways in which the parties may deviate from the statutory requirements which are outlined in the following non-exhaustive examples (*Regelbeispiele*):

Firstly, the parties may agree that the effects of the netting arrangements (contract termination and the emergence of a single compensation claim) may be triggered prior to the opening of insolvency proceedings, in particular when a petition for the opening of insolvency proceedings is filed or when a reason for the opening of insolvency proceedings is present (*Vorliegen eines Insolvenzgrundes*), e.g. one party is over-indebted or insolvent.

Secondly, the parties may agree to include those financial transactions of Sec. 104 para. 1 InsO that will become due before the opening of insolvency proceedings, but after the point in time, agreed for the contractual termination according to Section 104 (4) sentence 2 no. 1 InsO. This explicitly clarifies that the parties may contractually deviate from the requirement of Sec. 104 para. 1 InsO that the performance of the contractual obligation had to be subsequent to the opening of insolvency proceedings in case there is a contractual termination. Thus the contractual termination may replace (as regards timing) the opening of the insolvency proceedings.

Thirdly, the parties may – for the purposes of determining the market value of the replacement transaction – agree, that the point of time of the contractual termination replaces the commencement of the insolvency proceedings. They can also agree for the replacement transaction to be executed by the 20th business day following the contractual termination in so far as this is required for a value-preserving transaction. In any case the parties may choose to select a point in time between the termination of the transaction and the fifth business day thereafter. It is also possible that the parties agree on a synthetic calculation of the market price based on several transactions, by way of an open, transparent and non-discriminatory auction process or by a financial model, which includes all factors relevant for determining the price and is consistent with recognized evaluation methodology for financial instruments.

Effects of the InsO-Reform

The new law provides a more robust solution following the general administrative act by the Federal Financial Supervisory Authority, which was published on the same day as the BGH decision and intended to provide an interim solution. It also provides new opportunities for structuring the netting arrangements in the master agreements. The Association of German Banks (*Bankenverband*) will certainly collaborate with market participants to explore the opportunities provided by the new law and provide an update of the German Master Agreement for Financial Derivatives Transactions in the medium term. We also expect new netting opinions to be required.

Due to a special structuring of the law in three Articles, the amendments with respect to the possibilities to contractually deviate from the statutory concept have retroactive effect as of 10 June 2016 (Art. 5 para. 2 InsO-Reform). Thus, the new law limits the effects of the decision of the Federal Court of Justice, which it considers to be one-sided when holding certain netting arrangements to be invalid, to transactions in which insolvency proceedings have already been initiated before the decision on 9 June 2016. For all other transactions the new law granting substantially more freedom to contractually amend the statutory termination concept needs to be applied.

MiFID II/MiFIR Update

MiFID II/MiFIR Delayed

17 June 2016: Council adopted legislation extending the deadline for the application of MiFID II to 3 January 2018 and extending the deadline for transposition into national laws by 3 July 2017 "*to take account of the exceptional technical implementation challenges faced by regulators and market participants*".

Reporting Obligation (Article 26 of MiFIR / RTS 22)

28 July 2016: Commission adopted Delegated Regulation.

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

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

26 October 2016: ESMA Technical Reporting Instructions, MiFIR Transaction Reporting, published.

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

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

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

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

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

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

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

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

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

20 September 2016: ESMA published discussion paper seeking stakeholder's feedback on the options put forward by ESMA on how to calibrate the trading obligation. MiFIR foresees two tests to determine the trading obligation:

- **The venue test**: a class of derivatives must be admitted to trading or traded on at least one admissible trading venue; and
- **The liquidity test**: whether a derivative is 'sufficiently liquid' and there is sufficient third-party buying and selling interest.

The discussion paper includes options on how to determine the trading obligation by applying both tests, including an initial liquidity assessment on the basis of trading data for the six month to end-2015.

The consultation closed on 21 November 2016.

13 June 2016: Commission adopted further Delegated Regulations under MiFID II/MiFIR on direct, substantial and foreseeable effects of derivative contracts within the EU and the prevention of the evasion of rules and obligations ("**RTS 5**").

Publication of RTS 5 in Official Journal is on hold until Corrigendum is finalised.

UK Implementation

29 July 2016: FCA published second set of implementation proposals for MiFID II (CP16/19). This CP followed on from CP15/43, published in December 2015. In particular, the FCA proposed a new section of the Market Conduct Sourcebook to set out guidance and directions on the MiFID II regime for position limits, position management and position reporting for commodity derivatives contracts. The consultation closed on 28 October 2016. A policy statement is expected to follow in Spring 2017.

29 September 2016: The FCA has published its third consultation paper (CP16/29) on the implementation of MiFID II. In particular, MiFID II rules relating to structured deposits will be put into COBS (relating to e.g. inducement rules and independence standard for personal recommendations to retail clients in the UK). The consultation closed on 31 October 2016 for chapter 16 and 4 January 2017 for all other chapters.

Q2 2017: Policy statement expected.

Developments in Asia

2017 is the year of "margining" – MAS Publishes Guidelines on Margin Requirements for Non-centrally Cleared OTC Derivatives Contracts

Introduction

On 6 December 2016, MAS published its much-anticipated guidelines for the implementation of the margining regime in Singapore entitled "Guidelines on Margin Requirements for Non-centrally Cleared OTC Derivatives Contracts" (the "**Margin Guidelines**").[67] In line with the "Margin Big Bang" in Europe (see *European Margin Rules for Non-cleared OTC Derivatives – The Margin Big Bang* in this issue of The Delta Report), the Margin Guidelines take effect on 1 March 2017. This article provides a snapshot of the Margin Guidelines.

Structure of the Margin Guidelines

The 31-paged Margin Guidelines sets out the margin requirements over 11 main paragraphs and 5 annexes.

For ease of reference, the annexes cover:

Annex 1: Persons exempted from the margin requirements

Annex 2: Calculation of Initial Margin ("**IM**")

Annex 3: Credit Quality Grades

Annex 4: Standardised Haircut Schedule

Annex 5: Treatment of Initial Margin Collected

[67] On the same day, MAS also published its "Response to Feedback Received – Policy Consultation on Margin Requirements for Non-centrally Cleared OTC Derivatives Contracts" which provides insight into MAS' considerations in relation to the final provisions in the Guidelines and any variations between the proposed guidelines set out in MAS' "Policy Consultation on Margin Requirements for Non-centrally Cleared OTC Derivatives" issued on 1 October 2015 and the Guidelines.

The Margin Guidelines in summary

Which entities are subject to the margin requirements? **(Sub-paragraph 3.1)**	**"MAS Covered Entity"** • Banks licensed under the *Banking Act* • Merchant banks approved as financial institutions under Section 28 of the *MAS Act* that satisfies the following: • meets the S$5 billion threshold[68] • facing either another MAS Covered Entity that meets the S$5 billion threshold or a Foreign Covered Entity[69]	*Which entities are exempted?*[70] 1. The Singapore Government 2. Any statutory board established under written law 3. Any central bank in a jurisdiction other than Singapore 4. Any central government in a jurisdiction other than Singapore 5. An agency (of a central government described in (4)) incorporated in a jurisdiction other than Singapore, for non-commercial purposes 6. Various named agencies, organisations or entities (which include the International Monetary Fund and the International Finance Corporation)
Which transactions are subject to the margin requirements? **(Sub-paragraph 4.1)**	**"Uncleared derivatives contracts booked in Singapore"**[71] "**Derivatives contracts**" as defined in the SFA. Section 2 covers forwards, options and swaps (but not securities and futures contracts and therefore not repurchase agreements and securities lending transactions).	*Which products are exempted?* 1. Physically-settled FX forwards and swaps 2. Fixed physically-settled FX transactions associated with a principal-exchange cross currency swap 3. Commodity derivatives contracts entered into for commercial purposes 4. Uncleared derivatives contracts without a legally enforceable netting agreement[72] 5. Uncleared derivatives contracts without a legally enforceable collateral arrangement[73]

[68] The threshold is calculated against the aggregate month-end average notional amount of *uncleared derivatives contracts* booked in Singapore for March, April and May of the relevant year. "**Uncleared derivatives contract**" is defined in paragraph 2 of the Margin Guidelines. The term generally refers to *all* derivatives contracts (as such term is defined in SFA s 2) that are not centrally cleared (whether or not it is in-scope for the purposes of margining or traded with exempted entities). "**Derivatives contract**" specifically excludes securities and futures contracts.

[69] A "**Foreign Covered Entity**" is a person which is operating outside Singapore but which would be a MAS Covered Entity if it were operating in Singapore.

[70] See Annex 1.

[71] "**Booked in Singapore**" means the entry of the uncleared derivatives contract on the balance sheet of the person who is a party to the uncleared derivatives contract and whose place of business (for which the balance sheet relates) is in Singapore.

[72] In relation to such contracts, the Margin Guidelines provide that the MAS Covered Entity should undertake a legal review and document the basis of determining a netting agreement as non-legally enforceable (see sub-paragraph 4.3 of the Margin Guidelines).

Am I required to post IM, variation margin ("VM") or both from 1 March 2017? **(Paragraph 10)**	**VM**: Applies to *new*[74] transactions entered into after 1 March 2017 **IM**: Applies to *new* transactions entered into after 1 March 2017 or the relevant phase-in date in accordance with the phase-in schedule:[75] Threshold — Phase-in Date S$4.8 trillion — 1 Mar 2017 S$3.6 trillion — 1 Sep 2017 S$2.4 trillion — 1 Sep 2018 S$1.2 trillion — 1 Sep 2019 S$13 billion — From 1 Sep 2020 for each subsequent 12-month period	*How is the phase-in threshold applied?* The exchange of IM is only required if both the MAS Covered Entity (on a consolidated group basis) and its counterparty (on a consolidated group basis) each exceeds the respective threshold. For the purposes of calculating the phase-in threshold, intra-group transactions are excluded but includes uncleared derivatives contracts with exempted persons (listed in Annex 1) and out-of-scope products (listed in sub-paragraph 4.2). *What if I am already subject to a foreign jurisdiction's margining requirements?* Deemed compliance is possible in cross-border transactions where a foreign jurisdiction's margin requirements apply and are assessed to be comparable to the requirements in the Margin Guidelines.[76]
IM requirements **(Paragraph 5, sub-paragraphs 6.1 to 6.10, Annex 5)**	• Gross margining (ie no netting of IM amounts between counterparties) • Threshold: S$80 million (based on uncleared derivatives contracts between the MAS Covered Entity consolidation group and the consolidation group of its counterparty) • Minimum transfer amount: S$800,000 (for combined VM and IM transfers) • Margin calls made as soon as possible after transaction date ("**T**") or margin recalculation date ("**R**") but no later than T+1 or R+1 • Settlement within T+3 or R+3 • Calculations and methodologies in accordance with sub-paragraphs 6.1 to 6.10 and Annex 2	*Treatment of IM collected* • The MAS Covered Entity is not permitted to withdraw any IM from a trust or custody account except in the circumstances listed out at sub-paragraphs 3.1(a) to (d) in Annex 5. • Unless the parties have agreed otherwise, interest earned or distributions received from the IM collected accrues to the counterparty. • The MAS Covered Entity may re-hypothecate, re-pledge or re-use non-cash IM collected if all of the conditions listed out in sub-paragraphs 5.1(a) to m) in Annex 5 are satisfied.

[73] In relation to such contracts, the Margin Guidelines provide that the MAS Covered Entity should first consider alternative arrangements to safeguard IM collateral before determining that the collateral arrangement is not legally enforceable (see sub-paragraph 4.3 of the Margin Guidelines).

[74] An amendment to an existing derivatives contract does not qualify as a "new" derivatives contract.

[75] Margin Guidelines sub-paragraph 10.2, Table 1.

[76] Margin Guidelines paragraph 9.

VM requirements **(Sub-paragraphs 5.2-5.3, sub-paragraphs 6.11 to 6.13)**	• Daily margining • Zero threshold • Minimum transfer amount: S$800,000 (for combined VM and IM transfers) • Margin calls within T+1 or R+1 • Settlement within T+3 or R+3	The amount of VM required must be sufficient to fully collateralise the changes in the mark-to-market exposure of the uncleared derivatives contracts that are subject to the margin requirements. The VM should be calculated and posted on an aggregate net basis across all uncleared derivatives contracts, subject to a single, legally enforceable netting agreement.

Credit Quality Grades

Annex 3 set outs the relevant credit quality grades applied to the eligible collateral as follows:

	Credit Quality Grade						Short-term Credit Quality Grade			
	1	**2**	**3**	**4**	**5**	**6**	**I**	**II**	**III**	**IV**
Fitch	AAA AA+ AA AA-	A+ A A-	BBB+ BBB BBB-	BB+ BB BB-	B+ B B-	CCC+ CCC CCC- CC C D	F-1	F-2	F-3	Others
Moody's	Aaa Aa1 Aa2 Aa3	A1 A2 A3	Baa1 Baa2 Baa3	Ba1 Ba2 Ba3	B1 B2 B3	Caa1 Caa2 Caa3 Ca C	P-1	P-2	P-3	Others
S&P	AAA AA+ AA AA-	A+ A A-	BBB+ BBB BBB-	BB+ BB BB-	B+ B B-	CCC+ CCC CCC- CC C D	A-1	A-2	A-3	Others

Eligible Collateral and Haircuts[77]

Asset Type			**Haircut**[78]
Cash (no limit on type of currency)			0%
Gold			15%
Issued by Central Governments or Central Banks	Debt securities[79] with a credit quality grade of "1" or short-term credit quality grade of "I"	Residual maturity <= 1 year	0.5%
		Residual maturity > 1 year, <= 5 years	2%
		Residual maturity > 5 years	4%
	Debt securities with a credit	Residual maturity <= 1 year	1%

[77] Margin Guidelines Annex 4.

[78] The MAS Covered Entity should apply the haircuts as set out in Annex 4 of the Margin Guidelines. Internal or third party quantitative model-based haircuts should not be used for determining the haircuts to be applied to eligible collateral.

[79] For the purposes of eligible collateral, securitisations are not included in the scope of debt securities (Margin Guidelines FN 12).

Asset Type			Haircut[78]
	quality grade of "2" or "3" or short-term credit quality grade of "II" or "III"	Residual maturity > 1 year, <= 5 years	3%
		Residual maturity > 5 years	6%
	Debt securities with a credit quality grade of "4"	All maturities	15%
Issued by Financial Institutions	Debt securities with a credit quality grade of "1", "2" or "3" or short-term credit quality grade of "I", "II" or "III"	All maturities	20%
	Equity securities (including convertible bonds) in a main stock index of a regulated exchange		35%
Issued by other issuers	Debt securities with a credit quality grade of "1" or short-term credit quality grade of "I"	Residual maturity <= 1 year	1%
		Residual maturity > 1 year, <= 5 years	4%
		Residual maturity > 5 years	8%
	Debt securities with a credit quality grade of "1", "2" or "3" or short-term credit quality grade of "I", "II" or "III"	Residual maturity <= 1 year	2%
		Residual maturity > 1 year, <= 5 years	6%
		Residual maturity > 5 years	12%
	Equity securities (including convertible bonds) including in a main stock index of a regulated exchange		15%
Any unit in a collective investment scheme			Higher of 25% or the highest haircut applicable to any security in which the fund can invest
Additive haircut for currency mismatch between currency of the collateral and the currencies as agreed in the relevant contract, including termination currencies (does not apply to cash VM)			8%

HKMA issues guideline on exercising disciplinary power to order pecuniary penalty under the Securities and Futures Ordinance (Chapter 571)

Introduction

The Securities and Futures Ordinance (Chapter 571) ("**SFO**") regulates the financial products, securities and futures market and industry in Hong Kong. The SFO also provides a comprehensive civil and criminal regime to address misconduct in the financial markets. On 30 September 2016, the Hong Kong Monetary Authority ("**HKMA**") published a guideline on exercising disciplinary power to order a pecuniary penalty under the SFO ("**Guideline**"). The Guideline was issued by notice in the Gazette (G.N. 5461/2016) under Section 203C(1) of the SFO in respect of the OTC derivatives regime in Hong Kong.

Summary of the Guideline

Pursuant to Section 203A of the SFO, HKMA has the power to order a pecuniary penalty in circumstances where an authorised financial institution or approved money broker ("**Relevant Institution**") has breached any of the reporting, clearing, trading or record keeping obligations (together, "**Obligations**") to which it is subject. All decisions to order a pecuniary penalty will usually be publicised by HKMA as a matter of policy.

Section 203C(1) of the SFO further requires HKMA to publish the relevant guidelines that set out the manner in which it proposes to exercise its disciplinary power to order a pecuniary penalty. HKMA is required to have

regard to the published guidelines when exercising such power.

Other than the requirement that there be factors that must be taken into consideration by HKMA, there is no indication that any one or more of the other factors have greater significance than the others and will be taken into consideration at HKMA's discretion and if relevant to the particular case.

General factors

HKMA will take into consideration the following factors in exercising its power to order a pecuniary penalty:

(a) the order for pecuniary penalty should act as a deterrent to the Relevant Institution as well as other authorised financial institutions and money brokers from contravening their Obligations;

(b) the fine is determined at HKMA's sole discretion and will not necessarily be capped by the level set in Section 203A(1)(c)(ii);

(c) the financial resources of the person subject to disciplinary action ("Disciplined Person") such that the pecuniary penalty will not put such Disciplined Person in financial jeopardy;

(d) the seriousness of the contravention will be taken into account in determining the likelihood and size of the pecuniary penalty; and

(e) all the circumstances of the case.

Factors that must be taken into consideration

The factors that HKMA *must* take into consideration relate directly to the conduct of the Disciplined Person and these are set out at paragraph 9 of the Guideline as follows:

(a) whether the conduct was intentional, reckless or negligent;

(b) whether the conduct damaged the integrity of the securities and futures market or was potentially damaging or detrimental to the integrity of the securities and futures market or the financial stability of Hong Kong;

(c) whether the conduct caused loss to, or imposed costs on, any other person; and

(d) whether the conduct resulted in a benefit either to that person subject to disciplinary action or any other person.

Other factors (if relevant)

HKMA will also take into account the factors set out at paragraph 10 of the Guideline (if relevant to the particular case):[80]

(a) factors related to the nature, seriousness and impact of the contravention;

(b) the conduct of the Disciplined Person after the contravention i.e. whether any remedial steps have been taken and the degree of cooperation with HKMA and other competent authorities or law enforcement agencies;

(c) any relevant previous disciplinary record and compliance history of the Disciplined Person or any action taken (or likely to be taken) by other competent authorities for the same incident;

(d) whether HKMA has issued any guidelines in relation to the conduct in question;

(e) any action taken by HKMA and other competent authorities in previous similar cases;

[80] HKMA expressly states that this is not an exhaustive list and that some of the factors may not be applicable to a particular case but there are others that have not been included in the list which may be applicable (Guideline, paragraph 10).

(f) whether the conduct is widespread in the relevant industry;

(g) the Disciplined Person's experience in OTC derivatives; and

(h) whether Disciplined Person has promptly, effectively and completely brought the contravention to HKMA's attention and the reasons for the disclosure.

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