Joint ESAs' Consultation Paper on Draft Regulatory Technical Standards on risk-mitigation techniques for OTC derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 ("**EMIR**")

Linklaters' Response

We welcome the opportunity to respond to the Consultation Paper on Draft Regulatory Technical Standards on risk-mitigation techniques for OTC derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 (the "**Draft RTS**").

We have focused our comments on the following legal issues:

(i) Non-compliance of the Draft RTS with EMIR and Article 10 of the ESAs Regulation: entity scope and third country entities

(ii) Legal uncertainty around the meaning of "settlement currency"

(iii) Legal uncertainty around the right of the collateral taker to re-use VM

(iv) Incorrect application of 'minimum transfer amount' in Article 2 GEN

(v) Non-compliance of the Draft RTS with EMIR: entity scope and NFC-s / other exempt entities

Our response may be published.

1 Non-compliance of Draft RTS with EMIR: entity scope and third country entities

Legal basis of the Draft RTS: EMIR and ESAs Regulation

Pursuant to Article 11(15) of EMIR, the ESAs must develop common draft RTS that specify in more detail what the risk-management procedures referred to in Article 11(2) should be (including details on the levels and type of collateral and segregation arrangements).

According to Article 10 of the EU Regulation establishing the ESAs and their powers (the "**ESAs Regulation**")[1], such draft RTS can only "*be technical, shall not imply strategic decisions or policy choices and their content shall be delimited by the legislative acts on which they are based*".

Therefore, the rules set out in the Draft RTS must be technical in nature and reflect the scope and intention of the collateral obligation set out in EMIR. The relevant EMIR provisions in this context are Article 11(2) and Recital 24.

(a) Article 11(2): an obligation to exchange collateral

Article 11(2) of EMIR imposes an obligation on FCs and NFC+s (the "**in-scope entities**") to "*have risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral*" with respect to non-centrally cleared OTC derivatives (the "**in-scope derivatives**").

This obligation to <u>exchange</u> collateral implies an obligation on <u>both parties</u> to in-scope derivatives to <u>post and collect</u> collateral to and from each other, i.e. a two-way obligation

1 Regulation (EU) No 1093/2010

which can only apply if both parties are in-scope entities (but cannot apply if only one of the parties is).

(b) Recital 24: in-scope entities are those market participants subject to the clearing obligation

Recital 24 of EMIR provides that *"…market participants that are subject to the clearing obligation should have risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral*".

The intention is therefore clearly for the collateral exchange obligation to apply to the same market participants as those that are subject to the clearing obligation under EMIR - i.e. FCs, NFC+s and third country entities (TCEs) that would be FCs or NFC+s if they were established in the EU.

This also reinforces the principle that both parties must be in-scope entities for the obligation to apply, in the same way as the clearing obligation can never apply to one party unless it also applies to the other.

(c) Recital 24: Draft RTS to take into account the BCBS-IOSCO international standards

Recital 24 of EMIR also specifically requires ESMA to "*take into account the proposals of the international standard setting bodies on margining requirements for non-centrally cleared derivatives*" when preparing draft RTS specifying those risk management procedures.

The intention is therefore clearly for the ESAs to develop the Draft RTS in line with the BCBS-IOSCO international standards on margin requirements for non-centrally cleared derivatives (published in September 2013).

Why the Draft RTS are not in compliance with their legal basis

(a) Draft RTS: an obligation to collect

Although the Draft RTS impose an obligation to <u>collect</u> collateral (as opposed to an obligation to <u>exchange</u> collateral), such a collecting obligation is not as such necessarily contrary to Article 11(2), provided that both parties to the relevant derivatives contract are, in all circumstances, subject to that collecting obligation, as this would result in both parties, in effect, exchanging collateral.

If, however, the Draft RTS provide that, in certain circumstances, the collecting obligation can apply to one of the counterparties but not to the other, this would create a "one way" collateral collecting obligation (or, implicitly, a one-way collateral posting obligation), contrary to the exchange obligation provided for in Article 11(2).

It is therefore important that, pursuant to Article 10 of the ESAs Regulation and in order for the Draft RTS to be in line with the exchange obligation provided for in Article 11(2) of EMIR, <u>the collecting obligation should only apply if both counterparties to an in-scope derivative are subject to such a collecting obligation</u>.

Although this is currently the case in the proposed Draft RTS for in-scope derivatives between (i) two FCs, (ii) an FC and an NFC+ and (iii) two NFC+s,[2] <u>it is not currently the case where an FC or an NFC+ faces a TCE</u>, as the FC or NFC+ would currently have to collect collateral from such TCE regardless of whether or not such TCE is also subject to a

[2] It is also the case for two TCEs that would be subject to the collateral exchange obligation if they were established in the EU provided that those contracts have a direct, substantial and foreseeable effect within the EU or where such obligation is necessary or appropriate to prevent the evasion of any provision of EMIR, as set out in Article 11(12).

collateral collecting obligation (making it in such case a one-way obligation as opposed to an exchange obligation).

Therefore, the Draft RTS are currently not in compliance with their legal basis insofar as they impose a one-way collateral collecting obligation on an FC or an NFC+ when entering into an in-scope derivative with any TCE (as well as a one-way collateral posting obligation on that TCE) regardless of whether that TCE is also subject to a similar collecting obligation.

In order to resolve this issue, the Draft RTS should therefore be amended to ensure that, in the context of an in-scope derivative between an FC or an NFC+ and a TCE, the collecting obligation would only apply to the FC or NFC+ if the TCE were also subject to a collateral collecting obligation, i.e. where the TCE is also an in-scope entity (see our Conclusion for suggested amendments).

(b) In-scope entities

Although Article 11(2) only refers to FCs and NFC+s as the in-scope entities, Recital 24 clearly provides a legal basis for the Draft RTS to bring certain TCEs within the entity scope, as it provides that:

- the collateral exchange obligation should apply to market participants that are subject to the clearing obligation: this includes TCEs that would be FCs or NFC+s if they were established in the EU in circumstances where they enter into OTC derivative contracts with FCs or NFC+s and, and
- ESMA should take into account the BCBS-IOSCO international standards on margin requirements for non-centrally cleared derivatives when drafting the Draft RTS; such international standards make it clear that non-systemically important non-financial entities (as defined in the relevant jurisdiction, which in the EU corresponds to NFC-s) should not be subject to the collateral exchange obligation; the Draft RTS would therefore be contrary to one of the central principles of these international standards if they imposed any collateral posting obligation on TCEs that would be NFC-s if they were established in the EU.

Conclusion and suggested amendment to the Draft RTS

On the basis of the above, we suggest the following amendments (blue for new wording and red for deleted wording) to the definition of 'Counterparties' in Article 1 DEF and to Article 2 GEN (4)(b), as set out below.

Article 1 DEF – Definitions

"1. For the purposes of this Regulation, the following definitions shall apply:

(a) 'Counterparties' means financial counterparties within the meaning of Article 2(8) of Regulation (EU) No 648/2012, ~~and~~ non-financial counterparties referred to in Article 10 of Regulation (EU) No 648/2012, and any entity established in a third country that would be subject to the obligations of this Regulation if it were established in the Union."

We would also suggest amending the references to the term "counterparties" throughout the Draft RTS to the capitalised term ("Counterparties") in order to avoid any uncertainty around whether the reference means the specific entities in the defined term 'Counterparties', or any counterparty to a contract under the common meaning of the term (which would include any entity, regardless of its EMIR categorisation).

Article 2 GEN – Risk management procedures in specific cases

"[…]

(b) where they relate to transactions entered into with non-financial counterparties other than those referred to in Article 10 of Regulation (EU) No 648/2012 (or with non-financial entities other than those that would be referred to in Article 10 of Regulation (EU) No 648/2012 if they were established in the Union), they may agree not to exchange initial and variation margin;"

These amendments will ensure that the Draft RTS are in compliance with their legal basis, as:

- the Draft RTS will reflect the principle of a collateral exchange obligation in all circumstances (under no circumstances will there be a one-way collateral collecting/posting obligation)
- the Draft RTS will not impose any collateral exchange obligation on TCEs that would be NFC-s were they established in the EU, in compliance with Recital 24 and the BCBS-IOSCO international standards.

In addition, the suggested change to the definition of counterparties will ensure that the EUR 50 million threshold in relation to initial margin and the EUR 500,000 minimum transfer amount in relation to collateral payments will apply equally to transactions between EU counterparties and third country entities that are in scope, consistently with the BCBS-IOSCO international standards.

This is an important change, as otherwise the Draft RTS seem to provide that the thresholds may not be taken into account in transactions with TCEs. From the feedback provided by the ESAs at the EBA roundtable on 2 June 2014, we understand that this was not the intention, i.e. that the intention was for the thresholds to apply to transactions with TCEs as well as transactions between EU entities. This is consistent with the explanatory wording in the Consultation Paper which provides that the EUR 8 billion threshold from the BCBS-IOSCO international standards is intended to apply to TCEs: "*…all third-country entities, unless [they are] under the EUR 8 billion threshold*".[3]

2 Legal uncertainty around the meaning of "settlement currency"

There is no definition of "settlement currency" for the purpose of Paragraph 6 of Annex II (*Standard haircuts to the market value of collateral*), which applies where parties use the standard methodology to apply haircuts to the market value of collected collateral (as an alternative to using their own estimates), and provides that counterparties must apply a haircut of 8% to the market value of the assets where the collateral currency is different from the settlement currency.

The term "settlement currency" does not have a uniform meaning amongst market participants, and could have a number of meanings such as:

- the currency in which payments are made during the life of the transaction, including any payments on the scheduled termination date ("normal" / "business as usual" payments currency) – this is called the "***Contractual Currency***" under a standard ISDA Master Agreement
- the currency in which, following an event of default or termination event, the close-out amount (i.e. the amount owed by the "out-of-the money" to the "in-the-money" party) is

[3] Page 7 of the Consultation Paper, 3rd paragraph of the section entitled "Counterparties' risk management procedures required for compliance with Article 11(3) of Regulation (EU) No 648/2012")

payable - this is called the "***Termination Currency***" under a standard ISDA Master Agreement

- the currency into which parties to collateralised transactions convert all amounts under their derivatives positions as well as the market value of the collateral for the purposes of calculating the exposure of the counterparties to each other, and comparing it to the amount/value of any collateral that has already been posted - this is called the "***Base Currency***" under an ISDA Credit Support Annex.

Although there could be various Contractual Currencies under an ISDA Master Agreement (e.g. one different contractual currency per transaction), there would typically only be one Termination Currency, which would apply across all transactions under one ISDA Master Agreement for the purpose of the close-out netting following an early termination.

In order to avoid legal uncertainty and potential disputes arising as a result, we would suggest adding a definition of 'settlement currency' to Article 1 DEF.

3 Legal uncertainty around the right of the collateral taker to re-use VM

Some of the collateral management requirements set out in Article 2 LEC are inconsistent with the widely used practice of posting variation margin (VM) by way of title transfer, creating legal uncertainty around whether the collateral taker can indeed receive VM by way of title transfer and therefore have the right to re-use VM. We understand from feedback provided by the ESAs at the EBA roundtable on 2 June 2014 that the intention is indeed for the collateral taker to be able to use VM, as per the BCBS-IOSCO final standards.

Under title transfer, which is currently the prevalent way in which VM is posted under an ISDA English law Credit Support Annex (CSA), once Party A transfers collateral to Party B, that collateral belongs to Party B who is free to dispose of it as it wishes. Any requirements or restrictions imposed on Party B relating to that collateral (such as imposing that the collateral be held in particular accounts for example) would be inconsistent with title transfer and with the right of Party B to use that collateral.

By way of example, if on day 1, Party A has to post VM to Party B, and on day 2, following changes in the mark-to-market value of the derivative, Party B needs to post VM back to Party A, Party B would have to return *equivalent assets* to those it received from Party A. Party B may have disposed of these assets, in which case it would either have to purchase equivalent assets and deliver them to Party A. The fundamental point here is that, under title transfer, <u>Party A has no recourse or entitlement to any particular assets that may or may not be held by Party B</u>.

Title Transfer vs Security

On an early termination of the derivative contract following a default, where the collateral was posted under a security arrangement, the secured collateral would be liquidated and the proceeds applied to the close-out amount owed by one party to the other under the derivative contracts they have with each other. If Party A owes a close-out amount to Party B and, after Party B liquidates the collateral and applies towards the close-out amount, there are any unused proceeds, Party B will return them to Party A.

However, where the collateral was transferred by Party A to Party B under title transfer and Party A owes a close-out amount to Party B under the derivative contracts they have with each other, the market value of the collateral which has been transferred to Party B will be netted against the amount which Party A owes to Party B, giving rise to a "final" close-out amount owed by one party to the other. This will be the case regardless of what Party B has actually done with the collateral transferred to it by Party A – i.e. whether Party B is still holding the relevant assets or has sold them. The "final" close-out amount owed between the two parties therefore already reflects the reduced exposure that the counterparties have to each other following a default, as the market value of the collateral is deducted from the close-out amount due under the derivative transactions.

By way of illustration, payment obligations between counterparties would be netted as follows:

- Party B has a derivatives exposure to Party A of EUR100 million
- Party A has provided EUR 90 million worth of cash/assets to Party B
- upon Party A defaulting:
  - Party A will have an obligation to pay Party B EUR 100 million (the mark-to-market exposure under the derivative contract).
  - Party B will have an obligation to pay Party A EUR 90 million (the market value/cash equivalent of the assets that were delivered by Party A to Party B). This obligation replaces any obligation to deliver equivalent assets.
  - the obligations will be netted against each other (i.e. Party A's obligation to pay EUR 100 million will be netted against Party B's obligation to return EUR 90 million to Party A) thereby "applying" the collateral to reduce Party B's exposure to Party A.
  - as a result, Party A will owe EU 10 million to Party B (EUR 100 million – EUR 90 million).

Based on the above, the collateral management provisions set out in Article 2 LEC which impose:

- requirements for legal arrangements and a holding structure to access the received collateral if held in a third party custody (sub-paragraph (b)),
- requirements, where the collateral is held by the collateral provider, to have alternative custody accounts for the management of those assets following the default of the collateral provider (sub-paragraph (c)),
- requirements to have cash accounts with a party other than the collateral provider for depositing cash collateral (sub-paragraph (e)),
- requirements to be able to return the unused collateral proceeds to the liquidator or other insolvency official of the defaulted party (sub-paragraph (f)), and
- requirements to ensure that the accepted collateral is freely transferable, without any regulatory or legal constraints or third party claims, including those of the third party custodian, other than for costs and expenses incurred for that purpose (sub-paragraph (g)),

are only consistent with collateral being posted by way of security, but not with collateral being posted by way of title transfer. This is because, as noted above, the collateral provider (Party A in the above example) has no recourse or entitlement to any particular assets that may or may not be held by the collateral taker (Party B in the above example).

Conclusion and suggested amendment to the Draft RTS

As a result, although these requirements will be relevant for IM (given that IM will, as a matter of legal necessity in order to comply with the segregation requirements applicable to IM in the Draft RTS, have to be posted by way of security rather than title transfer), given that Article 2 LEC applies equally to IM and VM, it is important to clarify that sub-paragraphs (b), (c), (e), (f) and (g) only apply to security arrangements but not title transfer arrangements.

We would therefore suggest the following amendment to Article 2 LEC (additional wording in blue below):

"1. Risk management procedures of the counterparty receiving collateral shall include the following operational and technical capabilities:

(a) daily re-evaluation of collateral;

(b) legal arrangements and a collateral holding structure shall be in place to access the received collateral if held in third party custody;

(c) where the collateral is maintained with the collateral provider, alternative custody accounts for all asset types in the list of acceptable collateral for the management of the assets following the default of the collateral provider;

(d) access to an active outright sale or repurchase agreement market with a diverse group of buyers and sellers even in stressed market conditions and in the case of default of the collateral provider;

(e) cash accounts in all the acceptable currencies with a party other than the collateral provider for depositing cash collateral and for crediting the proceeds of repurchase agreements on the collateral;

(f) the ability to return the unused collateral proceeds to the liquidator or other insolvency official of the defaulted counterparty;

(g) arrangements to ensure that the accepted collateral is freely transferable, without any regulatory or legal constraints or third party claims, including those of the third party custodian, other than for costs and expenses incurred for that purpose) that impair liquidation or the return to the collateral provider on default of the collateral taker.

Sub-paragraphs (b), (c), (e), (f) and (g) shall only apply to variation margin where it has been collected pursuant to a security arrangement, but shall not apply where variation margin has been collected pursuant to a title transfer arrangement."

4 Incorrect application of 'minimum transfer amount' in Article 2GEN

Article 2 GEN (4) currently provides that the EUR 500,000 minimum transfer amount will apply to the total collateral amount.

This is not in line with the BCBS-IOSCO international standards, which provide that the EUR 500,000 minimum transfer amount should apply to margin transfers between parties; i.e. to the payments made between the parties on a daily basis (or more frequently if they wish) in order to adjust to the total collateral amount required.

For example: on day 1, Party A has to post a total collateral amount of EUR 800,000 to Party B. On day 2, Party A is further out-of-the-money and the total collateral amount owed to Party B is EUR 1,000,000. Party A therefore needs to make a "top up" payment of EUR 200,000 to Party B. If

Party A and Party B have agreed that the EUR 500,000 minimum transfer amount will apply, Party A will not have to post such additional EUR 200,000. If, on day 3, Party A is further out-of-the-money to the extent that it owes a total collateral amount of EUR 1,400,000, the "top-up" payment that Party A needs to make to Party B amounts to EUR 600,000. As this "top-up" amount is above EUR 500,000, Party A will have to post the entire EUR 600,000 amount to Party B.

Therefore, we suggest the following amendment to Article 2 GEN (4)(a)

"*4. By way of derogation from Article 1 GEN, for the purposes of paragraph 3 of Article 11 of Regulation (EU) No 648/2012, financial counterparties and non-financial counterparties as referred to in Article 10 of that Regulation may instead agree in writing or equivalent permanent electronic form on any of the following:*

(a) where a margin transfer between two counterparties as a result of changes to the total collateral amount as defined in paragraph 6 based on all OTC derivatives transactions between two counterparties is equal to or lower than EUR 500 000 (minimum transfer amount), they may agree not to exchange collateral. In case the margin transfer ~~total collateral~~ amount owed to the collateral taker exceeds the minimum transfer amount, the collateral taker shall collect the full margin transfer ~~total collateral~~ amount, without deduction of the minimum transfer amount."

5 Compliance of Draft RTS with EMIR: entity scope and NFC-s/other exempt entities

Imposing an obligation on:

(i) NFC-s and

(ii) entities referred to in paragraphs 4 and 5 of Article 1 of EMIR

to enter into risk management procedures (albeit for those procedures to provide that these entities agree not to exchange IM and VM) when they enter into in-scope derivatives with in-scope entities is contrary to the Level 1 EMIR text, as Article 11(3) doesn't apply to these entities.

Therefore, the Draft RTS should exempt them from the requirement to have risk management procedures in place, instead of imposing any obligation on them to have risk management procedures in place (even if those risk management procedures can specify that parties will not be exchanging collateral).

On the basis of the above, we suggest the following amendments to Article 2 GEN (blue for new wording, red for deleted wording and green for wording that has been moved):

"4. By way of derogation from Article 1 GEN, for the purposes of paragraph 3 of Article 11 of Regulation (EU) No 648/2012, financial counterparties and non-financial counterparties as referred to in Article 10 of that Regulation ~~may instead agree in writing or equivalent permanent electronic form on any of the following~~:

(a) may instead agree in writing or equivalent permanent electronic form, where the total collateral amount as defined in paragraph 6 based on all OTC derivatives transactions between two counterparties is equal to or lower than EUR 500 000 (minimum transfer amount), ~~they may agree~~ not to exchange collateral. In case the total collateral amount owed to the collateral taker exceeds the minimum transfer amount, the collateral taker shall collect the full total collateral amount, without deduction of the minimum transfer amount.

(b) need not, in relation ~~where they relate~~ to transactions entered into with non-financial counterparties other than those referred to in Article 10 of Regulation (EU) No 648/2012~~, they may agree not to~~ exchange initial and variation margin;

(c) need not, in relation ~~where they relate~~ to transactions entered into with entities referred to in paragraphs 4 and 5 of Article 1 of Regulation (EU) No 648/2012, ~~they may agree not to~~ exchange initial and variation margin;

(d) may instead agree in writing or equivalent permanent electronic form~~, they may agree~~ not to exchange initial and variation margin for indirectly cleared derivatives transitions that are intermediated through a clearing member or through an indirect clearing arrangement as long as a) the client or the indirect client is subject to the margin requirements of the CCP; or b) the client or indirect client provides margins consistent with the relevant corresponding CCP's margin requirements."

We would also recommend adding the following wording at the end of Article 2 GEN to clarify that FCs and NFC+s would still be able to agree alternative collateral arrangements (such as one-way collateral arrangements for example) when entering into in-scope derivatives with NFC-s (or any other out-of-scope entities):

"For the avoidance of doubt, parties referred to in paragraphs (b) and (c) are free to enter into any collateral arrangements as agreed between themselves."