COMMENTARY

EMIR Variation Margin Rules Effective March 1, 2017

One of the regulatory pillars of the European Market Infrastructure Regulation ("EMIR") is the requirement for parties to collateralize the marked-to-market exposure in over-the-counter derivatives transactions ("OTC derivatives") that are not cleared by a central clearing system. This requirement is commonly referred to as posting or exchanging variation margin ("VM").

Effective March 1, 2017, the VM requirement to post margin collateral under EMIR will apply to most counterparties entering into OTC derivatives with EU financial institutions. These requirements will have two major consequences for derivatives counterparties:

- Existing ISDA documentation that customarily governs OTC derivatives transactions will either require amendment or replacement with new, recently published ISDA documentation, which will ensure compliance; and
- Counterparties will need to consider whether administrative and operational systems are in place to manage and monitor the new margining requirements.

What Are the EMIR Margin Requirements?

EMIR specifies the following key practical components for determining a counterparty's VM requirements:

Marked-to-Market Valuation. The amount of VM to be posted is calculated by reference to a counterparty's credit exposure to the other party based on a marked-to-market value of the parties' OTC derivative contracts. Hence, a counterparty would be required to post margin collateral to the other party if the marked-to-market value of their transactions reflected a credit exposure to or "positive" value for the other party.

Daily Calculation. VM requirements must be calculated on each business day based on the previous business day's value for each transaction within a netting set. The Regulatory Technical Standards ("RTS") under EMIR defines a "netting set" as the uncleared OTC derivatives between two parties that are "subject to a legally enforceable bilateral netting agreement."

Collection of VM. A party required to post VM must provide the VM collateral within the same business day. This timing requirement may pose practical difficulties for affected counterparties located in different time zones.

Minimum Transfer Amount. The obligation to post VM is subject to a daily minimum threshold of €500,000 for each netting set—that is the obligation to post margin does not arise until the amount to be posted equals €500,000 or more. The parties may agree to a lower minimum threshold amount in their documentation.

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Eligible Collateral and Haircuts. The RTS sets out a list of collateral that is eligible for VM purposes, together with applicable "haircuts" on their value. This includes cash, gold, government issued securities, corporate bonds, the most senior tranche of a securitization, equities included in the main index, and units or shares in UCITS. Haircuts on the value of the collateral posted would also apply to all eligible collateral based on the credit quality and maturity of each type of collateral.

Which Uncleared OTC Derivatives Are Affected?

The new VM rules apply to all uncleared OTC derivative transactions entered into after March 1, 2017, for all OTC transactions, with limited exceptions for certain types of FX transactions. Generally, FX forwards, FX swaps, and cross-currency swaps are all within scope. However, physically settled FX forwards will have a delayed phase-in period, and single-transaction spot FX trades for most major currencies with a customary two-day settlement will be exempt.

Which Entities Are Affected by the New VM Rules?

Since January 2017, EMIR has required large counterparties with uncleared OTC derivatives in excess of €3 trillion to exchange VM. Beginning March 1, 2017, the VM requirements will extend to all other entities that are classified under EMIR as financial counterparties ("FC"), nonfinancial counterparties that have derivatives transactions exceeding the EMIR clearing thresholds ("NFC+"), as well as to transactions between such entities and any entities established outside the EU that would be a FC or NFC+ if established within the EU. Derivatives transactions between an FC or NFC+ with a nonfinancial counterparty that has derivatives transactions below the EMIR clearing thresholds ("NFC-") are also subject to the VM requirements.

Additionally, two non-EU FCs and NFC+s will be required to exchange VM if: (i) both such entities are acting through branches established in the EU; or (ii) either such entity benefits from a guarantee provided by a FC established in the EU if the guarantee covers derivative transactions with the aggregate notional amount exceeding €8 billion and is equal to at least five percent of the FC's total exposure to OTC derivatives.

In practice, most counterparties trading with an EU FC or NFC+ would be directly or indirectly affected by the new VM rules.

Documentation

From a documentation perspective, counterparties will generally have one of three options in order to meet the EMIR VM requirements:

Executing the VM Compliant Versions of the ISDA 2016 Credit Support Annex. For counterparties that presently do not collateralize their OTC derivatives or that are entering into new OTC derivatives master agreements, compliance may be ensured by entering into the ISDA 2016 Credit Support Annex for Variation Margin. This document may be governed by either English or New York law depending on the location of the securities and cash utilized for margining as well as the governing law of the related ISDA Master Agreement between the parties.

Amending an Existing CSA. Parties that presently have in place an ISDA Credit Support Annex may satisfy the VM documentation requirements by entering into a bespoke amendment agreement that incorporates the commercial terms and mechanics of VM under EMIR. A number of financial institutions have prepared such amendment agreements for their end user clients.

Adherence to the 2016 ISDA Variation Margin Protocol ("VM Protocol"). Parties may enter into an "adherence letter" evidencing adherence to the amendments provided under ISDA's published VM Protocol. The amendments effected under the VM Protocol are rather complex as the protocol is structured to cover a wide range of variables typically more relevant to financial institutions, including the location of the counterparty acting as a multibranch entity and the regulatory regime(s) that may apply to that counterparty or branch. For example, the VM Protocol covers counterparties that may be subject to the rules of the U.S. Commodity Futures Trading Commission, the Financial Services Agency of Japan, and EMIR.

In order to give effect to the VM Protocol, both parties to an ISDA Master Agreement must agree upon and exchange

"matched questionnaires" as prescribed by the protocol. The questionnaires are designed to evidence agreement on a number of operational and commercial terms between the parties (e.g., minimum transfer amounts). If the questionnaires do not match, then the protocol will not have any effect and the parties will have to resubmit their questionnaires to one another until matching questionnaires are achieved. Buy-side counterparties that are not subject to the multijurisdictional regulatory regimes covered by the VM Protocol may find it more practical to enter into a bilateral amendment.

Looking Forward

With a March 1, 2017, effective date looming, all users of OTC derivatives and related hedging instruments that are subject to EMIR should be giving careful consideration to their legal documentation and related operational systems so as to ensure timely compliance with VM Margin. Following March 1, 2017, uncleared OTC derivatives that are not in compliance will be prohibited under EMIR. Jones Day's multijurisdictional team of structured finance and derivatives lawyers stands ready to assist our clients in addressing the full range of these documentation and regulatory issues.

Lawyer Contacts

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