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FINANCIAL MARKETS LAW COMMITTEE

Discussion of legal uncertainties arising from the 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

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FINANCIAL MARKETS LAW COMMITTEE

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1. INTRODUCTION

1.1. The role of the Financial Markets Law Committee (the "**FMLC**" or the "**Committee**") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. In the context of OTC derivative contracts not cleared by a central counterparty (a "**CCP**"), Article 11(15) of Regulation (EU) No 648/2012 (the "**EMIR**") requires the European Supervisory Authorities (the European Banking Authority (the "**EBA**"), the European Insurance and Occupational Pensions Authority (the "**EIOPA**") and the European Securities and Markets Authority (the "**ESMA**") (together, the "**ESAs**")) to develop common draft regulatory technical standards specifying:

1.2.1. risk-management procedures regarding the timely, accurate and appropriately segregated exchange of collateral (required for compliance with Article 11(3) of the EMIR);

1.2.2. the level of capital to be held where collateral is not required to be exchanged (required for compliance with Article 11(4) of the EMIR);

1.2.3. the procedures for counterparties and the relevant competent authorities to be followed when applying the exemption for intragroup transactions (required for compliance with Article 11(6) to (10) of the EMIR); and

1.2.4. the applicable criteria for the identification of practical or legal impediments to the prompt transfer of own funds and repayment of liabilities between counterparties (required for compliance with Article 11(5) to (10) of the EMIR).

1.3. On 14 April 2014, the ESAs published a 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 the EMIR (the "**Draft RTS**").

1.4. The Draft RTS are divided into five Chapters, namely: (i) counterparties' risk management procedures; (ii) margin methods; (iii) eligibility and treatment of collateral; (iv) operational procedures; and (v) procedures concerning intragroup derivative contracts. Each Chapter is sub-divided into Articles identified by name.

1.5. The FMLC takes this opportunity to comment on certain issues of legal uncertainty arising under the Draft RTS, notably:

1.5.1. the application of the requirement to establish collateralisation procedures to third-country entities which would be classified as non-financial counterparties below the clearing threshold were they established in the EU ("**Third-Country NFC-s**");

1.5.2. the apparent incompatibility of the use of title transfer collateral arrangements with the requirement under the Draft RTS that initial margin be segregated; and

1.5.3. the application of the requirements of the Draft RTS to "excess collateral".

2. APPLICATION TO THIRD-COUNTRY ENTITIES BELOW THE EMIR CLEARING THRESHOLD

2.1. The explanatory text to the Draft RTS stipulates that EU entities will have to collect margin from all third-country entities (including Third-Country NFC-s), unless explicitly exempted by the EMIR or under the EUR 8 billion threshold. [2]

2.2. This policy objective has been implemented in the Draft RTS under Articles 1 and 2 GEN, which together provide that collateral must be collected in all dealings by financial counterparties ("**FCs**") and non-financial counterparties taking positions in OTC derivative contracts in excess of the clearing threshold ("**NFC+s**"), with limited exceptions. One such exception, as set out in Article 2 GEN, paragraph 4(b), favours dealings with non-financial counterparties (defined in the EMIR to include undertakings, other than CCPs and financial counterparties, *established in the Union*) taking positions in OTC derivatives contracts below the clearing threshold. There is no equivalent exception, however, for Third Country NFC-s.

[2] Paragraph 3 (Background and rationale), 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.

2.3. This outcome increases legal uncertainty for the reason that (i) it is unclear whether, during the period between the date of the entry into force of the EMIR (16 August 2012) and that of the entry into force of the Draft RTS, risk management procedures of FCs and NFC+s which enable collateral not to be collected from Third-Country NFC-s are compliant with the obligations of such FCs and NFC+s under Article 11(3) of the EMIR; and (ii) the requirement to collect collateral form Third-Country NFC-s appears inconsistent with international standards in the context of non-centrally cleared derivatives, notably the minimum standards for margin requirements for non-centrally cleared derivatives as agreed by the Basel Committee on Banking supervision (the "**BCBS**") and the International Organization of Securities Commissions (the "**IOSCO**") (the "**BCBS-IOSCO Framework**"). [3] Each of these issues of legal uncertainty is now discussed in turn.

(a) <u>Collection of collateral prior to entry into force of the Draft RTS</u>

2.4. Recital 93 of the EMIR states that

> Any obligation imposed by [the EMIR] which is to be further developed by means of delegated or implementing acts adopted under Article 290 or 291 TFEU should be understood as applying only from the date on which those acts take effect.

2.5. Article 11(15) of the EMIR states that draft regulatory technical standards, including those required for compliance with Article 11(3) of the EMIR, were to be submitted to the Commission by 30 September 2012. The Draft RTS have not yet been submitted to the Commission. Some uncertainty may now arise as to whether market practices which are at odds with the position adopted under the Draft RTS are nevertheless to be treated as compliant with the EMIR during the period before the Draft RTS comes into force. Any implication that the standards set out in the Draft RTS are merely a reflection of standards already implicit in the EMIR would exacerbate this uncertainty which arises as a consequence of the two-year delay in submitting the Draft RTS to the Commission.

[3] Margin requirements for non-centrally cleared derivatives, Basel Committee on Banking Supervisions, Board of the International Organization of Securities Commissions, September 2013

2.6. In the interim, the European Commission has provided the following clarification in its Frequently Asked Questions on the EMIR,[4] in paragraph I.6.:

> [Article 11(3)] is applicable from the entry into force of the Regulation. The precise level and exact type of collateral to be exchanged will be specified by further regulatory technical standards which will be by drafted jointly by the ESMA, EBA and EIOPA […].
>
> Before those technical standards enter into force, counterparties have *the freedom to apply their own rules on collateral in accordance with the conditions laid down in Article 11(3)*. As soon as the technical standards enter into force however, counterparties will have to change their rules to the extent necessary in order to comply with the standards. The technical standards will apply to relevant contracts concluded as of the date that they enter into force. (Emphasis added).

2.7. The FMLC understands that it is not uncommon for counterparties' own collateral rules to exempt or apply a zero level of collateral to certain transactions and/or certain counterparties. The FMLC further understands that such counterparties may include Third-Country NFC-s.

2.8. The Commission's guidance, therefore, will be taken to allow FCs and NFC+s, in accordance with their own collateral procedures, to opt not to collect collateral from Third-Country NFC-s (or indeed any entity other than another FC or an NFC+), during the period between 16 August 2012 and the entry into force of the Draft RTS.

2.9. The FMLC would welcome additional and specific confirmation that, during the period between 16 August 2012 and the entry into force of the Draft RTS, risk management procedures of FCs and NFC+s which enable collateral not to be collected from Third-Country NFC-s are permissible and within the bounds of the "freedom" identified by the Commission (above).

(b) <u>Divergence from the BCBS-IOSCO Framework</u>

2.10. Requirement 2 of the BCBS-IOSCO Framework states

4 EMIR: Frequently Asked Questions, updated 18 December 2013.

> 2.1 All covered entities that engage in non-centrally cleared derivatives must exchange, on a bilateral basis, the full amount of variation margin (ie a zero threshold) on a regular basis (eg daily).
>
> 2.2 All covered entities must exchange, on a bilateral basis, initial margin with a threshold not to exceed €50 million. […]
>
> 2.4 […] non-systemic, non-financial firms are not covered entities.

2.11. In the application of the requirement to exchange collateral, the BCBS-IOSCO Framework does not differentiate between non-systemic, non-financial firms on the basis of the location of their establishment: no such entity is a "covered entity".

2.12. By requiring collateral to be collected from Third-Country NFC-s, the Draft RTS therefore diverge from the BCBS-IOSCO Framework.

2.13. The FMLC wishes to highlight this divergence. A lack of harmonisation in the implementation of derivatives regulation increases legal uncertainty and the opportunity for regulatory arbitrage.

3. SEGREGATION OF INITIAL MARGIN

3.1. Collateral arrangements may, generally speaking, be divided into two categories, namely: (i) security collateral arrangements (which involve the creation of security by the collateral-provider over the collateral in favour of the collateral-taker); and (ii) title transfer collateral arrangements (which involve the transfer by the collateral-provider of its entire proprietary interest in the collateral to the collateral-taker and a contractual right to the return of equivalent assets to the collateral-provider).

3.2. In many jurisdictions, title transfer collateral arrangements are viewed by market participants as particularly sound from a risk management perspective because of the opportunity they create for simplified enforcement or realisation of the collateral (whether resulting from the absence of stays or simplified mechanics resulting in the application of the value of the collateral in satisfaction of amounts due). In the European Union, Directive 2002/47/EC of 6 June 2002 on Financial Collateral Arrangements (the "FCAD") reduces or eliminates the effects of differences between title transfer and security financial collateral arrangements by restricting the application of certain perfection and enforcement requirements relating to the latter. [5]

3.3. It is unclear, however, whether the Draft RTS permit initial margin to be transferred to the collateral-taker pursuant to a title transfer collateral arrangement. Article 1 SEG – *Segregation Of Initial Margins* – of the Draft RTS provides that

> 1. Collected collateral as initial margin shall be *segregated from proprietary assets* on the books and records of a third party holder or custodian, or via other legally effective arrangements made by the collecting counterparty;
>
> […]
>
> 4. The segregation arrangements shall meet both of the following conditions:
>
> (a) initial margins are immediately available to the collecting entity where the posting counterparty defaults;
>
> (b) the posting entity is *sufficiently protected* where the collecting entity enters bankruptcy or other insolvency proceedings. (Emphasis added).

3.4. The paragraphs below examine the effects upon the availability of title transfer collateral arrangements under the Draft RTS of the requirements that (i) initial margin be segregated from proprietary assets, and (ii) the posting entity be sufficiently protected where the collecting entity enters insolvency proceedings in turn.

(a) <u>Segregation from proprietary assets</u>

3.5. A title transfer collateral arrangement, by definition, involves the transfer of title to the collateral taker; as a consequence, collateral transferred pursuant to a title transfer collateral arrangement may, on one reading, be viewed as incapable of segregation from the "proprietary assets" of the collateral taker (since the collateral in question itself constitutes such an asset). Furthermore, as the collateral provider's asset will be its

[5] Nevertheless, in many jurisdictions, legal uncertainties are associated with security transfer collateral arrangements. Please see, for example, the FMLC paper entitled "Analysis of uncertainty regarding the meaning of "possession or … control" and "excess financial collateral" under the Financial Collateral Arrangements (No.2) Regulations 2003". A copy of that paper, as well as other FMLC papers and letters, is available at: http://www.fmlc.org/Pages/papers.aspx.

claim for delivery of equivalent assets, it is not clear what benefit segregation of the posted collateral would provide to the collateral provider.

3.6. The degree of segregation required by the Draft RTS is, however, unclear. In particular, the absence of an express reference to *the* proprietary assets *of the collecting counterparty* may suggest that the intention of the segregation requirement is to ensure segregation in fact, rather than in law. It is, for example, unclear whether it would be sufficient to meet the segregation requirements of the Draft RTS for collateral to be posted on the basis of a title transfer collateral arrangement provided that it were held in an individual account by a third party custodian.

3.7. The FMLC would welcome further clarification on this point.

(b) <u>Sufficient protection where the collecting entity enters bankruptcy or insolvency</u>

3.8. As noted above, paragraph 4(b) of Article 1 SEG requires that "the posting entity is sufficiently protected where the collecting entity enters bankruptcy or other insolvency proceedings".

3.9. Where collateral is provided under a title transfer collateral arrangement, the collateral provider has a claim for delivery of equivalent assets and its primary protection is usually an ability to net that claim against the collateral taker's claims against it: where such netting is available, it is unclear whether this constitutes "sufficient protection". Further arrangements may be entered into so as to provide additional protection to the collateral-provider against the default of the collateral-taker. For example, where collateral posted under a title transfer collateral agreement is held on a segregated basis in an account with a third party custodian, the collateral-taker could charge its rights over such account back to the collateral-provider. Such charge may or may not constitute a financial collateral arrangement within the meaning of the FCAD, but may, arguably, provide "sufficient protection" to the provider of the initial margin, within the meaning of Article 1 SEG.

3.10. The FMLC would welcome clarification as to the arrangements that would be considered "sufficient protection" for the purposes of the Draft RTS.

4. EXCESS COLLATERAL

4.1. Article 1 EIM – *Initial Margins* – of the Draft RTS stipulates that counterparties are obliged to calculate and collect initial margin using either the standardised approach or the initial margin models.

4.2. In accordance with Article 1 SMI – *Standardised Method*,

> When counterparties apply the Standardised Method, the initial margins for each netting set shall be calculated in accordance with the method referred to in Annex IV [to the Draft RTS].

4.3. Annex IV to the Draft RTS sets out, depending upon the asset class in question, certain standardised percentages by which the notional amount or underlying value of the derivative contract is to be multiplied as part of the calculation of the net initial margin to be collected.

4.4. Alternatively, Article 1 MRM – *Initial Margin Models* – states that an initial margin model may be (a) developed by one of the two counterparties or jointly by the two counterparties or (b) provided by a third party agent. The amount of margin to be collected with regard to a derivative contract is then calculated in accordance with such model.

4.5. Where the counterparties to a derivative contract agree that the amount of initial margin to be posted with respect to such contract is in excess of the amount calculated in accordance with either the standardised approach (under Article 1 SMI – *Standardised Method*) or an initial margin model (under Article 1 MRM – *Initial Margin Models*), the relevant provisions do not stipulate whether the excess collateral is subject to the requirements of the Draft RTS.

4.6. The FMLC welcomes clarification on this point, and, in particular, whether the following provisions of the Draft RTS apply with respect to excess collateral:

4.6.1. the restriction on rehypothecation, re-pledging or re-use of collateral provided as initial margin (under Article 1 REU – *Treatment Of Collected Initial Margins*); and

4.6.2. the eligibility criteria provided in Article 1 LEC – *Eligible Collateral for Initial and Variation Margin*).

5. CONCLUSION

The FMLC welcomes the specification of risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP, pursuant to Article 11(15) of the EMIR. It is concerned, however, that a number of legal uncertainties may arise from the provisions of the Draft RTS. These uncertainties are broadly identified as regarding: (i) the application of the requirement to establish collateralisation procedures to Third-

Country NFC-s; (ii) the apparent incompatibility of the use of title transfer collateral arrangements with the requirement under the Draft RTS that initial margin be segregated; and (iii) the application of the requirements of the Draft RTS to "excess collateral". Possible solutions, such as drafting or other recommended approaches are highlighted above, where applicable, for the consideration of the ESAs.

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