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Margin for Deliverable FX Forwards, and Commodity Derivatives Position Limits

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EMIR Margin Rules: FX (Fast) Forwards, Hit Pause or Eject?

Background

The European Markets Infrastructure Regulation[1] ("EMIR") requires that certain counterparties have "risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts". The regulatory technical standards developed in this regard, the EMIR Margin RTS[2], were published on 15 December 2016 and, inter alia, contained requirements relating to the collection of variation margin (i.e., the positive daily mark-to-market (or mark-to-model) value of contracts) which applied to all in-scope counterparties from 1 March 2017. However, given the operational difficulties faced in complying with the rules by that date, European Union ("EU") Member States' national competent authorities (each, an "NCA") were expected to exercise a case-by-case approach to enforcement of those requirements in the months following 1 March[3] (the "March Announcement").

The EU variation margin rules apply directly to a (i) 'financial counterparty' ("FC") and (ii) non-financial counterparty above the EMIR clearing threshold ("NFC+"). The rules also apply indirectly to a third country entity that would be categorised as an FC or as an NFC+ if it were established in the EU, which is facing an FC or an NFC+. Two third country entities facing each other may also be in-scope in certain circumstances (not considered further here).

Whilst the application of the variation margin requirements of the EMIR Margin RTS to physically settled FX forward contracts had been delayed, they are due to apply from 3 January 2018, although recent market expectation is that such requirements will be postponed or abandoned entirely for certain buy-side firms.

Such variation margin requirements would include:

- establishing, applying and documenting risk management procedures for the exchange of collateral for non-centrally cleared OTC derivative contracts;
- performing an independent legal review of the enforceability of netting and exchange of collateral agreements; and
- establishing policies to assess on a continuous basis the enforceability of such agreements.

Foreign Exchange Contracts

"Foreign exchange forwards"[4] (deliverable FX forwards) were the subject of a specific delay in the application of the EMIR Margin RTS variation margin rules[5]. Given the lack of an EU wide approach on what constitutes a spot trade versus a forward trade, their application was deferred until a harmonised definition of 'spot' transaction was agreed.

Forward (In-Scope) or Spot (Out-of-Scope)

The distinction was settled in Article 10 of Commission Delegated Regulation (EU) 2017/565[6] (which will be effective from 3 January 2018) which states that a spot contract shall be an exchange of one currency against another currency, under the terms of which delivery is scheduled to be made within the longer of the following periods (the “Spot Delivery Periods”):

- two trading days in respect of any pair of major currencies (being the US dollar (USD), Euro (EUR), Japanese yen (JPY), Pound sterling (GBP), Australian dollar (AUD), Swiss franc (CHF), Canadian dollar (CAD), Hong Kong dollar (HKD), Swedish krona (SEK), New Zealand dollar (NZD), Singapore dollar (SGD), Norwegian krone (NOK), Mexican peso (MXN), Croatian kuna (HRK), Bulgarian lev (BGN), Czech koruna (CZK), Danish krone (DKK), Hungarian forint (HUF), Polish złoty (PLN) and Romanian leu (RON);
- for any pair of currencies where at least one currency is not one of the major currencies listed above, the longer of two trading days or the period generally accepted in the market for that currency pair as the standard delivery period; or
- where the contract for the exchange of those currencies is used for the main purpose of the sale or purchase of a transferable security or a unit in a collective investment undertaking, the period generally accepted in the market for the settlement of that transferable security or unit in a collective investment undertaking as the standard delivery period, or five trading days, whichever is shorter.

There is also an anti-avoidance type provision in the Regulation which states that a contract will not be considered as a spot contract if there is an understanding between the parties that delivery of the currency is to be postponed and not performed within the Spot Delivery Periods, regardless of the contract’s explicit terms.

Therefore, if an FX contract does not qualify as a spot contract it will be a “derivative contract” (subject to the ‘commercial purpose’ derogation mentioned below) pursuant to EMIR and will be subject to all EMIR requirements, including the variation margin requirements of the EMIR Margin RTS with effect from 3 January 2018.

For completeness, further relevant EMIR provisions in relation to FX contracts are as follows:

- FX swaps, cross currency swaps and non-deliverable forwards (which are, in fact, treated as CFDs under MiFID II[7] and so could not be spot contracts) have been subject to the variation margin requirements since (at least) 1 March 2017;
- FX swaps, physically settled FX forwards and the exchange of principal in cross currency swaps are all exempt from the initial margin requirements pursuant to the EMIR Margin RTS;
- rolling spot FX are derivatives (either a forward or a CFD) rather than spot contracts; and
- under a “commercial purposes” exemption, physically settled FX contracts: (i) entered into in order to facilitate payment for identifiable goods, services or direct investment; (ii) which are not traded on a trading venue; and (ii) to which at least one party is not an FC, are not considered as financial instruments and would therefore be outside of the scope of EMIR and the EMIR Margin RTS.

AB Trading Advisors View and Comment

EU Harmonisation, but What About International Harmonisation?

The EU position requiring all physically settled FX forward transactions (i.e., including those entered into by end-users) to be subject to regulatory requirements relating to the exchange of variation margin is at odds with the approach of other significant derivatives markets. For example, both the United States (“US”) Commodity Futures Trading Commission and the US prudential regulators have exempted not only physically settled FX forwards from their margin rules, but also FX swaps and the fixed, physically settled exchange of principal in cross currency swaps.

Will there be a Delay Past 3 January 2018?

Recent developments and reported statements suggest that a delay is almost inevitable. The new rules may well be discarded altogether, in due course, for certain buy-side users.

EMIR Review

As part of the proposal to amend EMIR, a second Presidency compromise text on such proposal was published on 15 November 2017[8] (the “Second Compromise Text”) which included the following newly inserted provision:
“Physically settled foreign exchanged forwards shall not be subject to initial margins exchanges and shall only be subject to exchange of variation margins for transactions concluded between credit institutions authorised in accordance with Directive 2006/48/EC.”.

However, the review of EMIR, culminating in an amending regulation, will not be finalised by 3 January 2018; indeed, Q2 or Q3 of 2018 is a more realistic timeline. Therefore, any delay or exemption for certain firms would need to be effected through another mechanism or framework.

ESA Communication

On 24 November 2017, the European Supervisory Authorities (the “ESAs”), published a news statement[9] (the “ESA Statement”) pronouncing that they are reviewing the EMIR Margin RTS in order to develop amendments which will align the treatment of variation margin for physically settled FX forwards with the approach in other key jurisdictions (see our comment on harmonisation above). Specifically, the ESAs noted that in order to apply risk based and proportionate variation margin exchange rules to such contracts it would “most likely imply that the scope should cover transactions between institutions (credit institutions and investment firms)”. Interestingly, this is a wider application than that proposed in the Second Compromise Text. In relation to the specific 3 January 2018 date, the ESA Statement continues: “…as regards difficulties that in particular certain end-users are facing, the ESAs expect competent authorities to generally apply their risk-based supervisory powers in their day-to-day enforcement of applicable legislation in a proportionate manner”.

Timing

The ESA Statement commits to finalising its review and (if a solution is reached) submitting the draft amendments to the European Commission by 24 December. However, even with this expected timing, any legislative change to the EMIR Margin RTS seems unlikely before the 3 January deadline due to the generally unwieldy and time-consuming process of passing EU legislation.

What Does It Mean?

The ESAs’ comment for NCAs to “apply their risk-based supervisory powers” strongly suggests that either: (i) there will be general regulatory forbearance; or (ii) the NCAs will apply a case-by-case assessment on the degree of compliance and progress (in much the same manner as per the March Statement), to the physically settled FX forward variation margin requirement in the EU. We wait to hear for official announcements from the NCAs on this matter.

(Un-)Certainty and (Un-)Necessary Work

Buy-side market participants are in a potentially difficult position. Do they speculate on what is expected to happen and stop work on meeting the EU variation margin requirements for physically settled FX forwards and/or unwind arrangements already in place (since many existing agreements put in place for the 1 March requirements will automatically cover such contracts from 3 January 2018 as part of their existing terms), or continue to expend resources on what may ultimately be (or, indeed, is likely to be) a futile and unnecessary exercise? With MiFID II coming into effect on 3 January 2018, together with other EU regulatory initiatives during Q1 next year, firms cannot afford to spend time on unnecessary projects. Regulatory certainty and clarity should be prerequisites if firms are expected to assess the impact on their trading strategies and wider business, spend time and money on upgrading systems and documentation and implement processes and procedures. Statements such as "most likely to imply" do not provide the necessary certainty and clarity.

The industry has often expressed its objections to physically settled FX forwards being within the scope of the EU variation margining rules, but seemingly it is only now – less than six weeks before the 3 January 2018 deadline – that the ESAs have acknowledged this and its consequences. It is an undesirable state of affairs but market participants are (sadly) becoming familiar with last minute changes, uncertainties and clarifications as the key date of 3 January 2018 draws near: see, for example, the incomplete list of position limits (in our brief below), the consultation on the systematic internaliser tick size regime under MiFID II[10] and most things Brexit-related.

Uncertainty breeds anxiety and scepticism – two qualities that should not be associated with an effective regulatory regime.

United Kingdom ("UK") Trading Venue Commodity Derivatives Position Limits

Background

Article 57(1) of MiFID II states that NCAs must establish and apply position limits on the size of a net position which a person can hold at all times in commodity derivatives traded on trading venues and economically equivalent OTC contracts. (Of course, independently of this, a trading venue may develop and impose their own position limits as a means to control commodity derivative positions on such a venue.)

NCAs are required to determine (i) spot month position limits and (ii) other months' limits in a commodity derivative. This is done in accordance with a prescribed methodology[11] beginning with (subject to some specific derogations for certain commodity derivative contracts) a position limit baseline of: (i) 25% of the deliverable supply for that commodity derivative in the case of the spot month position limit; and (ii) 25% of the open interest in that commodity derivative for the other months' position limits. The NCA is then able to adjust the above baseline limits within a 5% to 35% range (subject to certain derogations) according to the impact of certain factors referred to in RTS 21 (such as maturity date of the contract, deliverable supply of the underlying commodity, number of market participants and characteristics of the commodity market) on the integrity of the market for that derivative and for its underlying commodity.

Once an NCA has proposed such position limits to ESMA, Article 57(5) of MiFID II requires ESMA to issue an opinion assessing the compatibility of such proposals with the MiFID II position limit objectives and calculation methodology within two months (the "MiFID II Opinion Requirement").

UK Sets Position Limits

On 24 October 2017, ESMA issued nine opinions agreeing with the position limits proposed by the UK Financial Conduct Authority[12] (the "FCA"). The relevant commodity contracts are on: (1) London cocoa; (2) Robusta coffee; (3) white sugar; (4) aluminium; (5) copper; (6) lead; (7) nickel; (8) tin; and (9) zinc. These position limits in respect of commodity derivative contracts trading on a UK trading venue were finally published by the FCA on 26 October 2017 and will apply from 3 January 2018.

Additionally, on 15 November 2017 and again on 28 November 2017, the relevant FCA position limits for commodity derivative contracts website was updated[13] to include further position limits. The position limits for 'Dated Brent' (which were originally published on 26 October 2017, see above) have also been updated to reflect the aggregation of this contract with the daily Dated Brent contract (which has the same underlying), inclusion in the definition of Brent oil of the Troll oilfield from January 2018, and inclusion of stock data. It should be noted that, at this stage, ESMA has not issued further opinions in respect of the new limits.

The FCA is required to review these position limits where there is a significant change in deliverable supply or open interest, or any other significant change on the market, based on its determination of deliverable supply and open interest, and to reset the position limit if necessary.

The FCA also noted that any other commodity derivatives traded on a UK trading venue which are not identified in the table published on the FCA website[14] will have a limit of 2,500 lots unless the position limit is set by another NCA.

ESMA List of Liquid Contracts

In terms of the liquid commodity derivative contracts identified by the NCAs that will receive a bespoke position limit, ESMA has published a list[15] but with a disclaimer that the list cannot be relied upon as being complete.

AB Trading Advisors View and Comment

Extra-territorial

The position limit requirements of MiFID II apply to "any person" holding a position in such commodity derivatives. Therefore, its application is extra-territorial and will apply to market participants outside of the EU and those not otherwise generally subject to the ambit of MiFID II.

Position Exemptions?

Position limits will not apply to positions held by or on behalf of a 'non-financial entity' and which are objectively measurable as reducing risks directly relating to the commercial activity of that non-financial entity[16]. However, the definition of 'non-financial entity' is intended to cover commercial hedgers and so expressly excludes alternative investment funds (AIFs) managed by authorised or registered alternative investment fund managers (AIFMs) and UCITS ManCos[17].

The exemption procedure requires the non-financial entity to demonstrate to the relevant NCA how the position it holds in a commodity derivative reduces the risk directly relating to the non-financial entity's commercial activity[18]. Any exemption is granted on a commodity derivative contract by commodity derivative contract basis. The NCA then has 21 days to approve or reject the exemption. A non-financial entity from outside the EU must also apply for an exemption in the same manner as an EU firm would.

If an exemption is approved, such risk-reducing positions held by the non-financial entity will fall outside the position limit regime and cannot be used to offset against other commodity derivatives positions which are subject to the limits.

Monitoring

All relevant entities trading commodity derivatives on EU trading venues (being EU regulated markets, multilateral trading facilities (MTFs) and organised trading facilities (OTFs)) and economically equivalent OTC contracts must familiarise themselves with the relevant spot month and other months' position limits and put in place appropriately robust monitoring procedures to ensure that such limits can be adhered to or positions reduced accordingly where no exemption is obtained. This includes being able to identify when an OTC contract (which can include a contract traded on a non-EU trading venue[19]) is economically equivalent to a commodity derivative traded on an EU trading venue so that such OTC contracts can also be included in the calculations (note that the FCA has said in its MiFID II commodity derivatives Q&A[20] that it will not be publishing a list of such economically equivalent transactions as it is the investment firm's responsibility to make this determination)[21]. Compliance is the responsibility of the position holder.

ESMA has stated that the position limits are applicable at all times (i.e., including outside the normal trading hours of a trading venue)[22]. Therefore, monitoring against the position limits must be continuous and intra-day.

In determining the net position held by a firm, it is important to ensure that: (1) the net position held in a commodity derivative must be separately determined for the spot month contracts and the other months' contracts; and (2) its holdings are aggregated with those held on its behalf at group level. The group level calculation requires particular attention in the context of an asset manager/fund relationship. We understand that the FCA has clarified that position limits will apply at the individual fund level and will not be aggregated at the manager level. However, will other NCAs follow suit?

Failure to comply with the position limits may result in sanctions, including fines of up to Euro 5 million (or twice the value of the benefit of the infringement) or a ban on participation in a trading venue.

Other ESMA Opinions?

Currently, other than the opinions in relation to the FCA's proposed position limits and despite the MiFID II Opinion Requirement, ESMA has published only three other opinions (in relation to rapeseed, corn and milling wheat contracts traded on Euronext)[23]. However, on 28 September 2017, ESMA released a public statement[24] stating that it would "… not be possible to finalise and publish all the position limit opinions for liquid commodity derivative contracts by the end of the year". As a result, it was agreed that NCAs will publish limits ahead of ESMA's opinions and such limits will be effective from 3 January 2018. Once ESMA is able to issue the relevant opinions, the relevant NCA will have to modify the position limits in accordance with the opinion (if necessary), or provide ESMA with a justification for why the change is not necessary.

Certainty

Market participants must have certainty as to the position limits in the relevant commodity derivative contracts in order to reduce positions sufficiently in advance or to be able to continue to trade with the certainty of being MiFID II compliant. That commodity position limits are being set, or remain unknown, this close to the 3 January 2018 deadline, introduces uncertainty both to the market and for participants (for example, will trades have to be unwound in a quicker-than-desired manner if limits are not provided in time?). Although there is an expectation that limits will be set at suitably high levels so that trading is not necessarily impacted, this is not a given, and stricter limits may result in a last-minute dash for compliance.

Contact Us

If you have any queries in relation to the above, or would like to discuss any related aspects more generally, please contact Antony Bryceson.

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[1] 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.

[2] Commission Delegated Regulation (EU) 2016/2251 supplementing EMIR. Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2251&from=EN

[3] See https://www.eba.europa.eu/documents/10180/1762986/ESAs+Communication+on+Industry+Request+on+Forbearance+Variation+Margin+Implementation.pdf

[4] Defined in Article 27(a) of the EMIR Margin RTS as: "physically settled OTC derivative contracts that solely involve the exchange of two different currencies on a specific future date at a fixed rate agreed on the trade date of the contract covering the exchange".

[5] See Article 37(2) of the EMIR Margin RTS.

[6] Commission Delegated Regulation 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive. Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0565&from=DA

[7] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast).

[8] Available at: http://data.consilium.europa.eu/doc/document/ST-14372-2017-INIT/en/pdf. A further draft is expected on 1 December.

[9] Available at: https://esas-joint-committee.europa.eu/Pages/News/Variation-margin-exchange-for-physically-settled-FX-forwards-under-EMIR-.aspx

[10] See https://www.esma.europa.eu/sites/default/files/library/esma70-156-275_cp_on_revised_rts_1.pdf

[11] Set out in Commission Delegated Regulation (EU) 2017/591 of 1 December 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for the application of position limits to commodity derivatives ("RTS 21").

[12] Available at: https://www.esma.europa.eu/press-news/esma-news/esma-agrees-mifid-ii-position-limits-proposed-fca

[13] See https://www.fca.org.uk/markets/mifid-ii/commodity-derivatives/position-limits

[14] Ibid.

[15] Following the hyperlink from https://www.esma.europa.eu/press-news/esma-news/esma-agrees-mifid-ii-position-limits-proposed-fca

[16] See Article 57(1) of MiFID II.

[17] See Article 2(1) of RTS 21.

[18] The FCA has produced an application guide available at: https://www.fca.org.uk/publication/forms/commodity-position-limits-exemption-application-guide.pdf

[19] See ESMA Opinion "Determining third-country trading venues for the purpose of position limits under MiFID II" available at: https://www.esma.europa.eu/sites/default/files/library/esma70-156-112_cdtf_opinion_eeotc_third_countries.pdf

[20] Available at: https://www.fca.org.uk/publication/minutes/mifidii-commodity-derivatives-qa.pdf

[21] Article 6 of RTS 21 sets out the criteria for determining whether an OTC derivative contract should be considered as 'economically equivalent'. It is a narrow definition: the OTC contract must be identical save for lot size, delivery dates provided there is no more than one day's discrepancy and post trade risk management arrangements (e.g. margining).

[22] See Answer 1 of Section 2 'Position Limits' in the ESMA Questions and Answers on MiFID II and MIFIR commodity derivatives topics, available at: https://www.esma.europa.eu/sites/default/files/library/esma70-872942901-28_cdtf_qas.pdf

[23] Available at: https://www.esma.europa.eu/press-news/esma-news/esma-agrees-first-position-limits-under-mifid-ii

[24] Available at: https://www.esma.europa.eu/sites/default/files/library/esma70-154-356_public_statement_revised_work_plan_waivers_and_position_limits.pdf