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New ISDA Credit Support Documentation for Variation Margin

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Do you need to take action?

Yes, if your fund trades privately negotiated or 'OTC' derivative transactions which are not subject to mandatory clearing ("Uncleared Derivatives") and is either itself subject to relevant variation margin ("VM") regulations or trades Uncleared Derivatives with a counterparty which is required to apply the relevant VM regulations in respect of your fund, your fund will need to have in place new VM regulatory compliant credit support documentation prior to 1 March 2017, being the date when, for the majority of market participants, the new VM regulations take effect.

In order to facilitate compliance with the upcoming VM requirements, the International Swaps and Derivatives Association ("ISDA") has published new regulatory compliant VM credit support annexes ("VM CSAs") which market participants can enter into, to ensure compliance. ISDA has also launched the ISDA 2016 Variation Margin Protocol (the "VM Protocol"), which enables adhering market participants to implement VM regulatory compliant documentation on similar terms to the VM CSAs through the mechanics of the VM Protocol.

VM start dates

The requirement to exchange VM is being phased in, with the following start dates:

1. Counterparties with an outstanding aggregate average notional amount of Uncleared Derivatives of over EUR 3 trillion are required to exchange VM with effect from the date falling one month after 4 January 2017; and
2. All other counterparties will be required to exchange VM from 1 March 2017 in respect of all Uncleared Derivatives entered into on or after that date.

In order to determine the correct start date, a calculation must be taken of the outstanding aggregate average notional amount of Uncleared Derivatives as of the last business day of March, April and May in each year (the first relevant year being 2016) with respect to the counterparty (or its group).

Reminder: who is subject to the VM requirements?

Any counterparty directly subject to Regulation (EU) No. 648/2012 known as the European Market Infrastructure Regulation ("EMIR"), as follows:

1. financial counterparties ("FCs") as defined under EMIR, which includes within its scope Undertakings for Collective Investment in Transferable Securities or 'UCITS' funds and Alternative Investment Funds ("AIFs") managed by authorised/registered Alternative Investment Fund Managers ("AIFMs") under Directive 2011/61/EU ("AIFMD"); and

2. non-financial counterparties (“NFCs”) as defined under EMIR, above the “clearing threshold” (“NFC+s”). NFCs are undertakings established in the European Union (“EU”) which are not FCs.

The “clearing threshold” is calculated on a rolling average basis over 30 working days. An NFC will be an NFC+ if one or more of the following thresholds is crossed:

Class of derivatives	**Threshold**
OTC credit derivative contracts*	EUR 1 billion
OTC equity derivative contracts*	EUR 1 billion
OTC interest rate derivative contracts*	EUR 3 billion
OTC foreign exchange derivative contracts*	EUR 3 billion
Other OTC derivatives contracts (including commodity derivative contracts)*	EUR 3 billion

* in gross notional value

If your fund is a third country entity (“TCE”) under EMIR (for example, because it is incorporated in the Cayman Islands but its AIFM is not authorised/registered as such with the UK Financial Conduct Authority (FCA) for AIFMD purposes) then, although the fund itself is not directly subject to the margin requirements, if it would be classified as an FC or as an NFC+ if it were established in the EU, its in-scope European counterparties are required, subject to limited exceptions, to exchange collateral with it.
Assuming that the correct classification for such a fund is a TCE which would be an NFC if it were established in the EU, the crucial issue is to determine whether the fund crosses the clearing threshold.

If there is any likelihood of crossing the threshold in the future, managers may choose to enter into new VM compliant documentation (to comply with the VM regulations) in order to ‘future-proof’ their trading documentation.

Other jurisdictions

Following publication of international standards for regulatory margin requirements for Uncleared Derivatives by the Basel Committee on Banking Supervision (“BCBS”) and the International Organization of Securities Commissions (“IOSCO”), regulators around the world have agreed to implement substantially similar margin rules, albeit not to the same timetable. The VM requirements in the United States (“US”), the EU, Japan and Canada go live on 1 March 2017. The VM requirements in Australia, Hong Kong and Singapore go live on 1 March 2017, with a six month transitional period during which compliance can be on a best efforts basis. The VM requirements in Switzerland are expected to apply from September 2017.
A fund and its manager may be subject to multiple regulatory regimes. ISDA’s Regulatory Margin Self-Disclosure Letter (“Self-Disclosure Letter”), which was published on 30 June 2016, enables a market participant to provide information in relation to the regimes applicable to it and to its counterparties. The Self-Disclosure Letter can be exchanged manually (i.e., in paper form), or through the online portal ISDA Amend.
A fund might need to complete multiple sections of the Self-Disclosure Letter, responding to questions in relation to (for example) both the

US and EU regulations. Responding accurately to questions (which themselves may appear unclear) relating to unfamiliar regulatory regimes can be challenging.

Why is new credit support documentation necessary, when existing credit support annexes ("CSAs") already allow for the exchange of VM?

Because the new VM regulations require that initial margin and VM are treated separately, and to ensure that the other regulatory requirements around the exchange of VM are appropriately documented.

VM margin regulations require that VM is actually exchanged. Until the introduction of the VM margin regulations, buy side market participants may have had the right to call for VM under their CSAs, but may not have exercised that right.

New ISDA Credit Support Documentation

Starting in April 2016, ISDA published a series of VM Credit Support Annexes ("VM CSAs") which are based on existing ISDA credit support documentation widely used in the market, but amended to include regulatory compliant provisions relating to VM.

In August 2016, ISDA published the ISDA 2016 Variation Margin Protocol ("VM Protocol"). Similar to other ISDA protocols, the main purpose of the VM Protocol is to provide a mechanism by which two parties can amend or supplement their existing ISDA Master Agreement documentation. The VM Protocol includes a set of amendments and supplemental terms to facilitate compliance with the new VM regulations. These amendments and supplemental terms have been carefully drafted by ISDA, with the aim of achieving widespread market 'buy-in' and a certain uniformity in terms used by market participants. Specifically, the VM Protocol allows adhering parties to make necessary amendments to their existing credit support documentation and/or to implement a new VM CSA on terms agreed between them, within the available choices under the VM Protocol.

To use the VM Protocol or not to use the VM Protocol?

Market participants have a choice. They can implement regulatory compliant VM credit support documentation by either:

1. private bilateral negotiations (in other words, exchanging drafts manually and signing paper copies); or
2. adhering to the VM Protocol and using the mechanisms of the VM Protocol to create new regulatory compliant VM credit support documentation.

Private bilateral negotiations of regulatory compliant VM credit support documentation may seem a cumbersome way to amend documentation, but the VM Protocol itself is also complicated.

The VM Protocol has, thus far, gained few adherents (238, as at 30 December 2016), which suggests that the majority of market participants are preferring to implement new regulatory compliant VM credit support documentation in the traditional way, i.e., repapering by exchanging and agreeing drafts, and signing execution copies. Market participants may also feel that this method affords more control and allows agreement of bespoke terms.

New VM Credit Support Documentation – what to expect?

VM CSAs are comprised of the following documents:

- the ISDA 2016 Credit Support Annex for Variation Margin (VM) (Security interest – New York Law);
- the ISDA 2016 Credit Support Annex for Variation Margin (VM) (Title Transfer – English Law); and

- the ISDA 2016 Credit Support Annex for Variation Margin (VM) (Loan – Japanese Law).

All VM CSAs are based on the existing versions of the relevant CSAs published by ISDA which are currently in widespread use, and hence will look familiar. Any new VM CSA should follow the form (New York law, English law or Japanese law) of any existing CSA between parties, and should in any event be consistent with the governing law of the underlying ISDA Master Agreement.

Key amendments

The following key amendments "convert" existing credit support documentation to become regulatory compliant for VM.

Scope

Each VM CSA will cover only transactions specifically designated by parties as "Covered Transactions".Parties will have flexibility in defining which transactions will be designated as "Covered Transactions" by reference to transaction date and transaction type.This allows parties to adjust a relevant VM CSA in accordance with applicable margin regulations.
For example, if the parties fall under the European margin regulations (i.e., EMIR), the term "Covered Transactions" should include "OTC derivatives" as defined under EMIR.Conversely, if the parties are subject to relevant US regulations, "Covered Transactions" should include "swaps" as defined in the US Commodity Exchange Act ("CEA") or "security-based swaps" as defined in the US Securities Exchange Act of 1934 ("SEA").Finally, if the parties are subject to both US and European regulations, the term "Covered Transactions" should include "OTC derivatives" as defined in EMIR, "swaps" as defined in the CEA and, if applicable, "security-based swaps" as defined in the SEA.

Credit Support Obligations

Delivery amount: the delivery amount applicable to the collateral giver (i.e., the amount of collateral required to be delivered to the collateral receiver) is based on the collateral receiver's exposure (i.e., the amount that would be payable to the collateral receiver by the collateral giver if all transactions were terminated as of the relevant valuation time), replacing the "Credit Support Amount" under traditional CSAs, which consists of the collateral receiver's exposure plus independent amounts (i.e., initial margin). This revision provides that independent amounts are excluded from the realm of the VM CSA.
Minimum transfer amount: minimum transfer amount, on the other hand, is kept intact and operates in the same way as under a traditional CSA. The amount can be designated by the parties, subject to a maximum of EUR 500,000/USD 500,000 (or an equivalent amount in another currency in which margins are normally exchanged, so long as this amount is recalibrated sufficiently frequently to maintain its effectiveness).
Threshold amount: the concept of a "Threshold" amount has been removed, i.e., the parties will not have the option of establishing a threshold amount for purposes of regulatory VM. This means that, once the minimum transfer amount is exceeded, the full amount of collateral must be exchanged.

Valuation

Under traditional CSAs, frequency of valuations of existing collateral and exposure can be specified by the parties.Under the new VM CSAs, valuations are carried out on a daily basis.
Where both parties are located in the same time zone, valuation should be determined as of the previous business day. Where the two parties are not located in the same time zone, valuation is to be determined at 4:00pm on the previous business day in the earlier time zone.

Transfer Timing

Depending on applicable margin regulations, a relevant VM CSA may establish more stringent timing deadlines for the transfer of collateral: the new concept of a “Regular Settlement Day” is introduced whereby if a demand for a transfer is received by the notification time (being either 10:00am New York time or 1:00pm London time), the relevant transfer must be made no later than the close of business on the same day on which the demand is made.

Interest Payments

VM CSAs introduce two methods for the payment of interest on cash collateral, “Interest Transfer” and “Interest Adjustment”:

1. Interest Transfer – if the parties elect Interest Transfer as the method for payment of interest, the parties will be able to net the interest amount due against a delivery amount or return amount, i.e., the delivery amount or return amount will be reduced by the interest payment amount; or
2. Interest Adjustment – if the parties elect Interest Adjustment as the method for payment of interest, the credit support balance held by the transferee/secured party will be either increased (in case the interest amount is a positive number) or decreased (in case the interest amount is a negative number).

Collateral Eligibility Conditions

Under the minimum standards for margin requirements for Uncleared Derivatives advanced by BCBS and IOSCO, assets collected as collateral for VM should be highly liquid (i.e., capable of being liquidated in a reasonable amount of time) and should “hold their value in a time of financial stress”.To comply with this key principle, national supervisors have developed their own list of eligible collateral assets.For example, the Regulatory Technical Standards (“RTS”) on risk mitigation techniques for Uncleared Derivatives under Article 11(15) of EMIR lists classes of assets which can be used for purposes of margin and imposes various procedures and conditions on credit quality of collateral, as well as requirements regarding the calculation and application of haircuts and criteria to ensure that collateral is sufficiently diversified and not subject to wrong-way risk.

In order for market participants to have necessary control and flexibility over acceptable collateral and to ensure their compliance with regulatory requirements, parties can specify conditions which must be met for collateral to qualify as “eligible collateral”.

Parties can agree more restrictive collateral requirements than required under the VM regulations, i.e., a subset of eligible collateral can be specified.A ‘Legal Ineligibility Notice’ procedure can be used under which a party receiving collateral can inform the other party that all or part of the delivered collateral has ceased or will cease to satisfy eligibility criteria previously agreed by the parties, along with the reasons why such collateral has ceased or will cease to be eligible.

It is likely that cash or highly-rated government securities will continue to be the dominant forms of collateral, although parties are free to choose from the wider range of assets as set out in the RTS.

A significant 8% “FX haircut” must be applied to non-cash collateral provided as VM which is denominated in a currency other than the base/termination currency. No haircut is applied in respect of cash margin provided as VM.

Credit Support Offset

The application of relevant VM margin regulations may result in circumstances whereby parties have multiple CSAs:

1. a CSA governing legacy transactions (i.e., transactions which are not subject to the applicable VM regulations); and

2. a new VM CSA covering new transactions which are subject to the applicable VM regulations.

In such circumstances, parties may elect “Credit Support Offsets” whereby they agree to offset transfers of credit support due under a VM CSA against transfers of credit support due on the same date under any other CSA between the parties, provided that the credit support is fully fungible.The option to offset will not, however, be available for credit support which is required to be segregated (i.e., regulatory initial margin, to be covered in a future AB Brief).

How does the VM Protocol work?

The VM Protocol is a questionnaire style of protocol which allows adhering parties to agree to regulatory compliant collateral terms for VM. The VM Protocol consists of the following documents:

1. Adherence letter – this document evidences an adhering party’s agreement to the terms of the VM Protocol. Similar to other ISDA protocols, the VM Protocol adherence letter must be submitted by an adhering party via instructions on the ISDA website (www.isda.org) along with a fee of USD 1,000;
2. Protocol – this document outlines the procedure for amending existing credit support documentation or for creating new regulatory compliant credit support documentation. It also sets forth the conditions that must be met for the questionnaires (as described below) to be deemed “matched”;
3. Questionnaire – this document sets forth a series of questions to be completed by each adhering party. The answers given by adhering parties determine how the VM Protocol will apply to the relevant counterparty pair, and what will be the end result of the VM Protocol for that counterparty pair; and
4. Exhibits – these documents are the “end products” of the VM Protocol. The exhibits comprise three amendments to the different CSAs (i.e., New York law, English law and Japanese law) and three new VM CSAs (again, New York law, English law and Japanese law). The amendments set forth specific terms to amend existing credit support documentation, while the new VM CSAs contain new sets of terms to be put in place between the two parties. The parties choose, through the elections made and information provided by the parties in questionnaires exchanged between them, whether to amend or to select a new VM CSA.

The core task in relation to the VM Protocol involves completing the questionnaire. Each adhering party is required to make various elections and to provide certain information about itself. For example, an adhering party will be required to specify the regulatory regimes applicable to itself, the scope of products to be covered by the new VM credit support documentation, and so on. One of the key elections to be chosen by each adhering party is the method to be used by the counterparty pair to produce regulatory compliant VM credit support documentation.

The VM Protocol provides market participants with the following methods to produce regulatory compliant VM credit support documentation (“Methods”):

1. “Amend Method” – this Method involves amending the terms of an existing CSA in accordance with applicable VM regulatory requirements. The end result is one amended CSA which will cover all transactions, including legacy transactions;
2. “Replicate-and-Amend Method” – this Method involves replicating the existing CSA and amending the replica CSA to incorporate regulatory compliant terms. The end result will be two CSAs: the existing CSA will continue to cover legacy transactions and the new amended replica CSA will cover new transactions subject to relevant VM regulations; or
3. “New CSA Method” – this Method involves entering into a new VM CSA based on a version of the relevant VM CSA published by ISDA. The end result will be two CSAs: the existing CSA will continue to cover legacy transactions and the new VM CSA will cover new

transactions subject to relevant VM regulations. (Unlike the "Replicate-and-Amend Method", existing/previously negotiated terms will not be preserved for transactions subject to relevant VM regulations.)

Once all necessary elections have been made by the two adhering parties (including election of the Method), the completed questionnaires are exchanged between them to form a counterparty pair. The exchange of questionnaires can be done either by bilateral delivery from one adhering party to another or online via ISDA Amend (http://www.markit.com/product/isda-amend). In case of the latter, the exchange of information and elections between two parties is automated and enhanced with various helpful features, such as the ability to customise information and elections on a counterparty-by-counterparty basis, and the ability of an adhering party to "practice" completion of the questionnaire in a "draft mode" with a preview of resulting collateral terms with its counterparty, before final exchange of the questionnaires. If all of the elections made by the two adhering parties within the counterparty pair are matched, the exchange of the matched questionnaires produces the results outlined above. Conversely, unmatched questionnaires (i.e., where parties make inconsistent elections or where one or both has not made any election) will not produce any result under the VM Protocol, and the parties will need to amend and re-submit their questionnaires.

Impact on prime brokerage models

Prime brokers are having to rework some of their documentation to allow for the exchange of VM. Many buy side entities will have previously negotiated 'two way' CSAs whereby they have the right to call for collateral to cover VM, but many will not have exercised that right in practice. The new regulatory VM requirements mean that prime brokers and other trading counterparties must now exchange VM. This is resulting in a broader reworking of prime brokerage models to include a 'working' VM CSA under which transfers of collateral in respect of VM are made automatically.