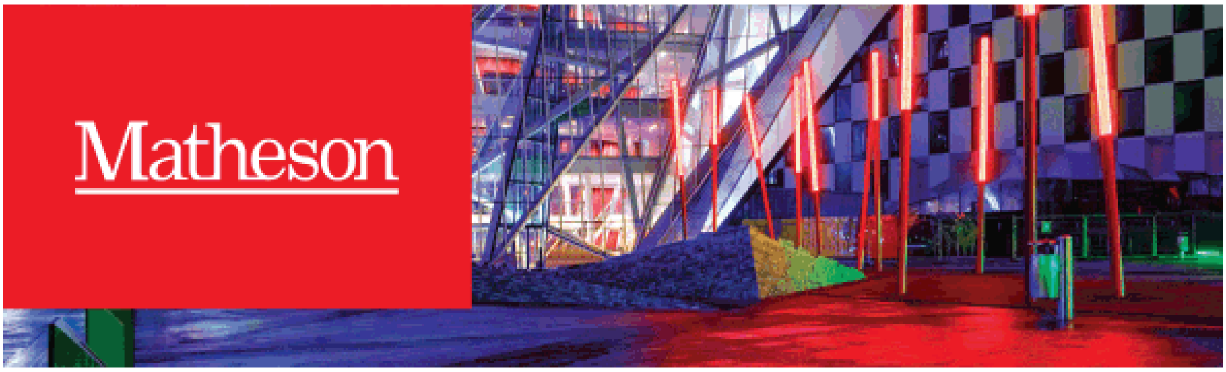

EMIR Variation Margin Rules – What do managers of Irish UCITS and AIFs need to know?

The European Market Infrastructure Regulation ("**EMIR**") requires certain EU counterparties, including Irish undertakings for collective investment in transferable securities ("**UCITS**") and alternative investment funds ("**AIFs**"), to put in place risk mitigation procedures prior to entering into OTC derivatives trades. This obligation includes a requirement to have in place procedures for the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivatives trades entered into on or after 16 August 2012 (the date EMIR came into force).

Over the past few years, European authorities have been working on Regulatory Technical Standards ("**RTS**") detailing the procedures that must be put in place to comply with the EMIR collateral obligation. Until these RTS enter into force, counterparties are free to apply their own collateral procedures.

In October 2016 the European Commission adopted a Delegated Regulation setting out the final RTS in relation to the exchange of collateral. The Delegated Regulation was formally approved by the Council of the EU on 21 November 2016, but has not yet been published in the Official Journal of the EU. While the Delegated Regulation will only enter into force 20 days after such publication, as the RTS have been finalised and adopted, counterparties can now prepare for the new rules in relation to the exchange of variation margin (the "**VM Rules**").

We set out below answers to the 10 questions most frequently asked by managers of Irish UCITS and AIFs regarding the VM Rules.

1. **Will UCITS and AIFs be subject to the VM Rules?**

   All "*financial counterparties*" under EMIR will be subject to the VM Rules. This includes all Irish UCITS and almost all Irish AIFs[1].

2. **When will the VM Rules enter into force?**

   The VM Rules enter into force on the later of 1 March 2017 or one month after the Delegated Regulation enters into force. Provided that the Delegated Regulation is not delayed, we expect the VM Rules to take effect on **1 March 2017**, and counterparties should now be planning accordingly.

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1. The VM Rules do not apply to AIFs that are not managed by Alternative Investment Fund Managers (AIFMs) authorised or registered in accordance with the Alternative Investment Fund Managers Directive (Directive 2011/61/EU), unless the AIF exceeds one of the EMIR clearing thresholds set in accordance with Article 10 of EMIR and relevant secondary legislation.

Significantly, physically settled FX forwards have a temporary exemption from the VM Rules until the earlier of the date from which MiFID II applies (currently expected to be **3 January 2018**) or 31 December 2018.

3. **What contracts will be subject to the VM Rules?**

Any OTC derivative trades entered into by a "*financial counterparty*" from 1 March 2017 will be subject to the VM Rules. Trades entered into prior to 1 March 2017 may continue to be subject to any existing collateral procedures that the counterparties have in place.

4. **What documents do we need to amend or agree?**

Entities subject to the VM Rules must have procedures specifying the terms of any netting agreement and exchange of collateral agreement to be entered into prior to commencing trading with a counterparty. For most Irish UCITS and AIFs they will continue to trade under a standard ISDA Master Agreement (netting agreement) and Credit Support Annex ("**CSA**") (exchange of collateral agreement).

Under the RTS the netting agreement and exchange of collateral agreement must be subject to an independent legal review of enforceability, which may be conducted by an internal independent unit or an independent third party.

It is likely that a UCITS / AIF's CSA will need to be amended, or the fund may need to put in place several parallel CSAs per counterparty, each with a different netting set (for example, one CSA for legacy trades, and one CSA for trades from 1 March 2017) in order to reflect new VM Rules requirements.

5. **What margin will be eligible under the VM Rules?**

Only certain types of collateral may be collected under the RTS, including:

(a) cash;

(b) gold;

(c) debt securities issued by an EU Member State government or central bank;

(d) debt securities issued by a third country government or central bank;

(e) debt securities issued by credit institutions or investment firms;

(f) corporate bonds;

(g) certain equities included in an index specified under Commission Implementing Regulation 2016/1643 (as may be amended); and

(h) shares or units in UCITS that meet certain eligibility conditions (as set out below).

The assets at (d) - (h) above may only be accepted if they are not issued by the posting counterparty or a member of its group, and are not otherwise subject to significant wrong way risk. An Irish UCITS or AIF must assess the credit quality of any non-Euro denominated bonds in accordance with the VM Rules.

We are aware of some fund managers considering whether one sub-fund of an umbrella UCITS fund could obtain shares or units in another sub-fund of the same umbrella UCITS fund under a swap or collateral transformation service, and use those shares or units to post as collateral.

While collateral posters may not use securities issued by a member of its group, recital 13 to the RTS states (in the context of calculating group level thresholds for determining when initial margin requirements should apply) that "*investment funds should be treated as a special case*", and that "*funds that are distinct pools of assets and [that] are not collateralised, guaranteed or supported by other investment funds or the investment manager itself… should therefore be treated as separate entities when calculating the thresholds…*" It is unclear whether this recital could also be used to support an argument that separate sub-funds are not part of the same group for the purposes of determining collateral eligibility.

If shares or units in a UCITS are used as collateral;

(a) they must have a daily public price quote;

(b) the UCITS must be limited to investing in assets that are eligible collateral under the RTS, and if it invests in both eligible and non-eligible collateral only the portion of the unit as relates to an investment in eligible collateral may be counted towards the VM Rules collateral value; and

(c) the UCITS must meet the criteria laid down in Article 132(3) of the Capital Requirements Regulation (Regulation (EU) No 575/2013).

6. **Do we have to apply a haircut to collateral received?**

Counterparties are obliged to haircut the value of collected collateral based on (i) a methodology set out in Annex II to the RTS, or (ii) their own volatility estimates calculated in accordance Annex II to the RTS.

According to the Annex II methodology cash variation margin is subject to a 0% haircut, while debt securities are subject to haircuts ranging from 0.5% to 15% depending on the issuer, credit rating and residual maturity. For eligible shares or units in UCITS the haircut to be applied is the weighted average of the haircuts that would apply to the assets in which the particular UCITS is invested.

A haircut of 8% must be applied for all non-cash collateral which is exchanged as variation margin and denominated in a currency other that those agreed in the individual derivative contract, governing master netting agreement or credit support annex

7. **How often should the transfer amount be calculated?**

Counterparties must calculate the variation margin to be collected on at least a daily basis. Where the counterparties are located in the same time-zone the calculation should be based on the netting set of the previous business day. Where the counterparties are located in different time-zones the calculation should be based on the transactions in the netting set which are entered into before 16:00 on the previous business day (determined based on the time zone where it is 16:00 first).

8. **What is the deadline for transferring margin?**

In general, variation margin must be transferred on the same day the calculation is performed.

As an exception to same-day transfer, variation margin can be transferred within two business days of the calculation date where the counterparties have agreed to exchange initial margin and have adjusted the method for calculating such initial margin to take account of the longer period for posting variation margin.

9. **Can we apply a minimum transfer amount?**

Yes – counterparties can agree a minimum transfer amount not to exceed EUR 500,000 (or equivalent in another currency). Where the collateral due exceeds the minimum transfer amount the collecting party must collect the gross amount due, without deduction of the minimum transfer amount.

10. **What should we do to prepare for the VM Rules?**

Any existing transaction documentation should be reviewed and updated to ensure that they are compliant with the VM Rules. Irish UCITS and AIFs will need to consider whether trades entered into prior to 1 March 2017 should constitute a legacy netting set and remain subject to existing collateral arrangements, or whether they should be migrated to new EMIR compliant arrangements. This decision will determine whether there are one or two netting sets outstanding between the counterparties, and could affect exposure calculations.

The International Swaps and Derivatives Association ("**ISDA**") has prepared a protocol including standard documentation allowing counterparties to:

(a) add a new credit support annex for variation margin to the parties' existing ISDA Master Agreement;

(b) amend an existing credit support annex to comply with the RTS;

(c) replicate and amend an existing credit support annex to apply to new trades only; or

(d) create a new ISDA Master Agreement and credit support annex for variation margin.

Further details on the ISDA protocol are available on the ISDA website. Irish UCITS and AIFs should consider carefully, and take legal advice, prior to adhering to the protocol. The ISDA protocol is relatively complex and we would be happy to assist you through the relevant adherence process. In many instances it may be more appropriate to review and bilaterally amend existing credit support annexes instead of adhering to the ISDA protocol. Again, we would be happy to advise and assist you in any such amendment negotiations.

Please get in touch with your usual Structured Finance and Derivatives Group or Asset Management and Investment Funds Group contact or any of the contacts listed in this publication should you require further information in relation to the material referred to in this update.

Full details of the Structured Finance and Derivatives Group or Asset Management and Investment Funds Group, together with further updates, articles and briefing notes written by members of the Structured Finance and Derivatives Group Asset Management and Investment Funds team, can be accessed at www.matheson.com.

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