Feature

KEY POINTS

- The European Commission has proposed amending EMIR to reclassify all EU alternative investment funds (regardless of whether they are managed by a manager authorised under AIFMD) as "financial counterparties" (ie counterparties required to margin their derivatives transactions).
- This may require funds that have not done so already to put in place new legal documentation, such as the 2016 ISDA Credit Support Annex for Variation Margin (along with new operational procedures and administrative systems), or to consider alternative structures (such as an SPV) in order to implement their risk management strategies.
- Expectations are that physically-settled foreign exchange rate forwards will however remain out of scope for margining (the exchange of collateral) for many of those funds.

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Changes to the legal and regulatory landscape for fund-level derivatives transactions

This article considers how certain alternative investment funds (currently those managed by a manager authorised under the Alternative Investment Fund Managers Directive and potentially, in future, *all* EU alternative investment funds) may need to update their legal documentation in order to margin (exchange collateral on) their derivatives transactions. It also touches upon whether alternative structures are available to allow funds to execute their risk management strategies without the need to margin.

THE LANDSCAPE TODAY

On 1 March 2017, Commission Delegated Regulation (EU) 2016/2251 (Margin RTS) came into effect, making fund-level hedging conducted by certain alternative investment funds (AIFs):

- more costly, because of the need to fund margin using cash as collateral; and
- more complex, because of the need to put in place operational procedures and administrative systems in order to exchange this collateral as margin on a daily basis.

The AIFs affected are those managed by a fund manager authorised or registered under Directive 2011/61/EU (the Alternative Investment Fund Managers Directive, AIFMD) (AIFM). This is because an AIF managed by an AIFM is a Financial Counterparty (FC) under Regulation (EU) No 648/2012 (EMIR) and, under EMIR, FCs are required to post and receive collateral as margin in respect of most new over-the-counter (OTC) derivatives transactions. Legacy OTC derivatives transactions allowed to run to maturity are, for the most part, grandfathered (but may be brought in scope by a lifecycle event, such as a novation or rollover).

The Margin RTS applies to swaps, options and most forwards (subject to one important exception, set out in more detail below) which are used by many funds (particularly in the private equity/real estate and infrastructure markets) as part of their risk management strategies.

For the purpose of this article, we have focussed on foreign exchange rate and currency hedging, which is relevant to a wide range of funds operating across different sectors, rather than more specialised asset classes.

THE CHANGING LANDSCAPE

The fund market has made significant advances in adapting to the requirements of the Margin RTS. However an impending change will broaden the number of AIFs impacted: earlier this year the European Commission published a proposal for a new regulation to amend EMIR which would, among other things, reclassify as FCs all AIFs established within the EU (regardless of whether they are managed by an AIFM). The result would be that all such AIFs will be required to exchange margin in respect of their OTC derivatives transactions.

SCOPE

This article will consider, in brief:

- how in-scope funds (ie currently, AIFs managed by AIFMs and, if the European Commission proposals become law, all EU AIFs) may need to update their legal documentation in order to margin their OTC derivatives transactions – specifically the need to put in place an exchange of collateral agreement (ECA) in order to comply with the terms of the Margin RTS.
- whether alternative structures are available to in-scope funds, to allow them to continue with their risk management strategies without the need to margin; and
- the last-minute changes to the rules that apply to physically-settled foreign exchange rate forwards.

DOCUMENTING LEGAL TERMS

In-scope funds that use OTC derivatives transactions as part of their risk management strategies are likely to already have in place International Swaps and Derivatives Association, Inc (ISDA) Master Agreements with their sell-side counterparties.

Some will also have Credit Support Annexes (CSAs) in place, in the 1995 form (1995 CSA), to facilitate the exchange of collateral in respect of out-of-the-money OTC derivatives transactions. Until 1 March 2017, this was not a legal or regulatory requirement but rather a matter for commercial negotiation.

A 1995 CSA is an acceptable form of ECA, however older documentation may not comply with the requirements of the Margin RTS, so care should be taken to ensure it is compliant. Alternatively, in-scope funds may elect to put in place a (now relatively market-standard) 2016 form CSA for Variation Margin (2016 VM CSA), which has been drafted to meet the ECA requirements of the Margin RTS.

When negotiating a 2016 VM CSA, in-scope funds will need to consider:

- Collateral eligibility (para 11(c)(ii) of the 2016 VM CSA) – most likely restricted to cash collateral denominated in the base currency of the fund. If the fund is concerned about the impact of negative interest rates (para 11(g) of the 2016 VM CSA) (for example if it is a Euro denominated fund) it may wish to include other major currencies such as GBP or USD, should these be available to it (for example under a credit line). It is unusual for funds to use non-cash collateral.
- Collateral haircuts (also para 11(c)(ii) of the 2016 VM CSA) – for cash collateral, funds should seek a valuation percentage of 100%. Funds should ensure, where more than one currency is eligible as collateral, that it is either a major currency (para 11(v)(B) of the 2016 VM CSA) or specified as an eligible currency (para 11(a)(ii) of the 2016 VM CSA) to avoid the application of an 8% FX haircut percentage, prescribed under the Margin RTS.
- The minimum transfer amount (MTA) (para 11(vi) of the 2016 VM CSA), below which collection of collateral is delayed until the MTA is met. This can be no higher than €500,000, as prescribed under the Margin RTS.

Unlike the position pre 1 March 2017, it is no longer possible for there to be a "threshold amount" (of a party's exposure) – namely an uncollateralised buffer, below which OTC derivatives transactions do not need to be margined. The inclusion of a threshold amount, envisaged by the 1995 CSA (albeit as a matter for commercial negotiation), is one of the primary reasons why the terms of a 1995 CSA would need to be amended to ensure they meet the ECA requirements of the Margin RTS.

- Collection timing (when collateral must be delivered) (see para 11(d) of the 2016 VM CSA). The timing for delivery of collateral has been accelerated significantly by the Margin RTS, which requires same-day or T+1 delivery.

While this article focuses on legal issues, in-scope funds will be concerned to ensure that they have sufficient liquidity available to them (cognizant of the corresponding costs and investment drag), whether this is sourced from investors or other credit lines, as well as ensuring that they have the necessary operational procedures and administrative systems in place to manage the exchange of collateral on a daily basis. Sell-side counterparties, commercial advisers and technology providers can offer assistance with these practicalities.

ALTERNATIVE STRUCTURES

As an alternative to executing OTC derivatives transactions at the level of the AIFs, it may be possible instead to:

- Conduct a broadly-similar risk management strategy but executed on an investment-by-investment basis, for example using an acquisition stack company as the counterparty to an OTC derivatives transaction relating to a particular investment only.
- Replicate an existing risk management strategy using a special purpose vehicle (SPV) as the counterparty to OTC derivatives transactions.

There is no particular requirement for the form of the acquisition stack company or the SPV – the important factor for funds is to ensure that the acquisition stack company or SPV, as the case may be, does not fall within the exhaustive list of FCs contained in EMIR (otherwise it would itself be required to margin any OTC derivatives transactions).

HEDGING USING AN ACQUISITION STACK COMPANY

The key disadvantage of conducting a risk management strategy on an investment-by-investment basis is that it limits flexibility, such as the ability to net across multiple OTC derivatives transactions referable to multiple investments. Other considerations include that an ISDA Master Agreement, or similar documentation (such as a long-form confirmation), would need to be put in place for each OTC derivatives transaction (unlike an SPV based structure where one ISDA Master Agreement could govern the terms of all OTC derivatives transactions across all investments) and on-boarding (a time consuming exercise) would be required with each sell-side counterparty on every investment (unlike an SPV based structure where this should only be required once, at the outset of any relationship with a sell-side counterparty).

HEDGING USING AN SPV

The European Securities and Markets Authority (ESMA) has published a series of questions and answers that relate to EMIR (the Q&As).

Q&A "General Question and Answer" 3(iv) refers specifically to SPVs used by private equity and real estate AIFs (but, by extension, could reasonably apply to funds investing in other asset classes). ESMA states that an SPV in a private equity structure whose purpose is to "purchase, hold or administrate undertakings" can be used to enter into OTC derivatives transactions "for the activity of the AIFs". As noted above, provided that the SPV does not fall within the exhaustive list of FCs contained in EMIR, it should be out of scope of the Margin RTS.

Feature

Biog box
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It is worth noting that the use of any alternative structure requires careful consideration from a legal, regulatory, tax, accounting, operational and administrative perspective. For the purpose of this article, we have assumed that OTC derivatives transactions are used for risk management only (a different analysis may apply to funds utilising OTC derivatives transactions for speculative purposes).

PHYSICALLY-SETTLED FOREIGN EXCHANGE RATE FORWARDS

From 3 January 2018 (the date on which the amendments to Directive 2004/39/EC, known as MiFID II, came into effect), physically-settled foreign exchange rate forwards have been in-scope for margining (until now these have been out of scope). This is particularly relevant for many AIFs, whose use of OTC derivatives transactions at fund level tends to be focussed on physically-settled foreign exchange rate forwards.

There was relief in the investment funds market, however, when on 15 November 2017 the Council of the European Union proposed that certain terms of EMIR be amended to bring them in line with regulatory regimes in other jurisdictions (notably the US). For the purpose of this note, the key proposal was that the majority of AIFs should not be required to margin physically-settled foreign exchange rate forwards. On 18 December 2017, the European Supervisory Authorities published their final report (endorsing the Council's position) and a formal amendment to EMIR is now subject to the legislative process, something which requires the assent of the European Parliament.

Until EMIR is amended formally, many UK funds have got comfortable relying on the FCA's statement that it will not require AIFs whose physically-settled foreign exchange rate forwards are likely to be outside the scope of the amended EMIR requirements to continue putting processes in place to exchange collateral as margin. Note however, under the latest proposals, "credit institutions" (see the Capital Requirements Regulation (EU) No. 575/2013) and "investment firms" (see MiFID II) would still be required to margin physically-settled foreign exchange rate forwards. Careful analysis is therefore required, as the proposed changes do not amount to a blanket exemption. ■

Further Reading:

- Margin for error (2016) 6 JIBFL 351.
- All clear? Client clearing of OTC Derivatives (2016) 1 JIBFL 38B.
- LexisNexis Financial Services blog: EMIR: One Minute Guide.