EMIR Margin requirements for physically settled FX forwards: the time to engage is now

Amid the noise of MiFID2, it would perhaps be easy to forget that the final piece of the EMIR Margin requirements, which relates to physically settled FX forwards, is due to come into force on 03 January 2018.

For firms which did not cover off FFX in their 01 March 2017 upgrades, these changes will involve new/uplifted documentation, potentially new collateral management systems or solutions, new/uplifted derivatives risk management procedures, and an ongoing obligation to ensure the enforceability of netting and collateral arrangements.

That is a lot to do in six months - and at a time when minds are focusing on the altogether bigger beast of MiFID2. The time to engage is now.

Background

Given the lack of a harmonised Europe-wide definition of spot FX, the EMIR Margin RTS (EU 2016/2251), included a phase-in of the variation margin (VM) requirement for physically settled FX forwards (or deliverable FFX) until 03 January 2018.

It is a somewhat unwelcome quirk of EMIR that physically settled FX were made subject to VM (although excluded from initial margin (IM)). Other jurisdictions, and in particular the US, had excluded physically settled FX trades from the margin obligation entirely.

Historically, many managers have traded FX:

- on an undocumented basis (ie without a netting agreement), or
- under another form of master agreement (eg an IFEMA), and in each case
- on an uncollateralised basis.
Such an approach will in most cases not be valid from 03 January 2018.

Who does the obligation apply to?

From an asset manager’s perspective, the requirement to exchange VM for physically settled FX forwards will apply to each of the following:

- financial counterparties (FCs) (including UCITS, AIFs with authorised AIFM and most EU pension schemes)
- non-financial counterparties above the EMIR clearing threshold (NFC+) (including EU AIFs with non-EU AIFMs, where the AIF exceeds any one of the EMIR clearing thresholds), and
- third county entities (TCEs) which would be an FC or NFC+ if established in the EU, when the TCE is facing an FC or NFC+ counterparty.

What transactions will be caught?

The phase-in to 03 January 2018 applied to “foreign exchange forwards”, which are defined in the EMIR Margin RTS as follows:

“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”.

This is distinguished from FX swaps and the exchange of principal on currency swaps, for which the 01 March 2017 deadline applied (subject to the various statements on forbearance from ESMA and various national competent authorities).

What about spot FX?

Spot FX will not be subject to the VM requirements, and from 03 January 2018 there will for the first time be an EU-wide definition of spot (see Article 10 of the MiFID2 Delegated Regulation (EU 2017/565) of 25 April 2016 (the “Delegated Regulation”)).

In summary, a spot FX will be a contract for the 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:

a. two trading days in respect of any pair of the Major Currencies (see below)
b. for any pair of currencies where at least one currency is not a Major Currency (see below), the longer of two trading days or the period generally accepted in the market for that currency pair as the standard delivery period, or
c. 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 a unit in a collective investment undertaking as the standard delivery period or five trading days, whichever is shorter.

The “Major Currencies” for this purpose are: the US dollar, Euro, Japanese yen, Pound sterling, Australian dollar, Swiss franc, Canadian dollar, Hong Kong dollar, Swedish krona, New Zealand dollar, Singapore dollar, Norwegian krone, Mexican peso, Croatian kuna, Bulgarian lev, Czech koruna, Danish krone, Hungarian forint, Polish złoty and Romanian leu.
An FX trade which is not a spot under the new definition will be treated as a derivative for EMIR (and MiFID2) purposes, including from a margin and reporting perspective, from 03 January 2018.

What about NDFs?

Under Recital 12 of the MiFID2 Delegated Regulation, non-deliverable forwards will be treated as contracts for difference (CFDs) and as such cannot be considered to be spot contracts, irrespective of their settlement period. (NDFs are in any event already subject to the EMIR VM requirement.)

What are the EMIR requirements?

The principal obligation will be for affected counterparties to exchange VM on physically settled FX forwards in a manner compliant with the EMIR Margin RTS from 03 January next year.

Managers who have historically traded physically settled FX forwards on an undocumented (ie without a netting agreement) and/or uncollateralised basis will need to establish the necessary documentation. Likewise, firms who have used documentation other than an ISDA Master Agreement (eg an IFEMA) will most likely need to transition over to the ISDA base.

Our experience is that this papering/repapering can be a time-consuming process, and it is therefore important for firms to engage with it as soon as possible.

In addition, however, the EMIR Margin RTS includes a number of ancillary obligations that will need to be satisfied, including the following requirements:

- to establish, apply and document risk management procedures for the exchange of collateral on uncleared OTC derivatives (there are specific requirements under the RTS for what these need to contain) - to be tested, reviewed and updated as often as necessary and at least annually
- to perform an independent legal review of the enforceability of netting and collateral arrangements, and policies to establish on a continuous basis the enforceability of such arrangements.

We have developed an online tool, the Simmons & Simmons Netting + Collateral Reviewer designed to facilitate compliance with this obligation. Please contact Craig Bisson or your usual Simmons contact for further information.

Is there anything else we need to do?

UCITS managers will need to consider the detailed requirements for collateral set out in ESMAs Guidelines on ETFs and other UCITS issues, particularly the requirement for a haircut policy and a collateral policy if these have not already been disclosed (or should they need updating in light of the EMIR VM requirements).

UCITS managers using FX forwards as part of a share class hedging currency overlay should consider the impact of collateral, taking into account ESMAs recent Opinion to the Commission (see our article).

Firms may wish to check that the terms of their segregated mandates allow them to collateralise physically settled forward FX trades as required by EMIR from 03 January 2018.

Will there be any forbearance?
Given that the requirements were finalised at the end of 2016, and market standard terms have been available for some time, we expect that the European regulators will have limited sympathy for any firms who fail to put the required arrangements in place by the 03 January 2018 deadline.

Any other developments in the FX space that I should know about?

Firms active in the FX market should also be aware of the new FX Global Code of Conduct (the Code), a voluntary code intended to promote the integrity and effective functioning of the global wholesale FX market, as a supplement to local laws and regulation.

The Code applies to all FX Market Participants, including sell-side and buy-side entities (the Code expressly refers to asset managers, hedge funds and pension schemes), non-bank liquidity providers, operators of E-trading Platforms, and other entities providing brokerage, execution and settlement services.

It is organised around the following six leading principles:

1. **Ethics**: Market Participants are expected to behave in an ethical and professional manner to promote the fairness and integrity of the FX Market.

2. **Governance**: Market Participants are expected to have a sound and effective governance framework to provide for clear responsibility for and comprehensive oversight of their FX Market activity and to promote responsible engagement in the FX Market.

3. **Execution**: Market Participants are expected to exercise care when negotiating and executing transactions in order to promote a robust, fair, open, liquid, and appropriately transparent FX Market.

4. **Information Sharing**: Market Participants are expected to be clear and accurate in their communications and to protect Confidential Information to promote effective communication that supports a robust, fair, open, liquid, and appropriately transparent FX Market.

5. **Risk Management and Compliance**: Market Participants are expected to promote and maintain a robust control and compliance environment to effectively identify, manage, and report on the risks associated with their engagement in the FX Market.

6. **Confirmation and Settlement Processes**: Market Participants are expected to put in place robust, efficient, transparent, and risk-mitigating post-trade processes to promote the predictable, smooth, and timely settlement of transactions in the FX Market.

Each of the above leading principles, is supported by a number of supplementary principles - there are 55 principles in total.

The FCA has indicated that it will use the Code to measure compliance with “proper standards of market conduct” as required by the Individual Conduct Rules in the FCA Handbook.

The steps firms should take to align their activities with the principles should reflect an internal assessment based on the nature, size and complexity of their engagement in the FX market.
Conclusion

Firms which trade physically settled FX forwards on an undocumented (ie without a netting agreement) and/or uncollateralised basis, or who have otherwise been relying on the phase-in to 03 January 2018, should be engaging now to establish EMIR compliant VM arrangements. There will be a lot to do.

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