

MACFARLANES

Phase 6 regulatory initial margin

Key considerations

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Background

Phase 6 represents the final stage of the phase-in of the rules for regulatory initial margin (Reg IM). Earlier phases are discussed in our previous notes covering **obligations on the buy-side** and the general **implementation of EMIR margin rules**. Reg IM requires counterparties to OTC derivatives to post margin on a segregated basis to cover current and potential future exposure during the period between the last margin collection and the time it takes close out derivative positions following the default of the counterparty.

While previous stages have predominantly affected sell-side entities and a small number of buy-side firms, Phase 6 applies to entities with uncleared OTC derivatives portfolios of €8bn or greater. This is expected to catch a larger number of the buy-side. Entities caught by Phase 6 must post Reg IM from **1 September 2022**.

Identify which of your entities are caught

To do this you will need to identify:

- The relevant margin rules applicable depending on where you are located¹.
- Your counterparty type – you will be covered by UK/EU margin rules if you are:
 - a financial counterparty²;
 - a non-financial counterparty above the clearing threshold²; and
 - a third country entity satisfying certain requirements².
- Your average aggregate notional amount (AANA) of uncleared OTC derivatives calculated on the last business day of March, April and May of 2022. If this is greater than €8bn, UK/EU margin rules apply to you. You should start working out **now** whether you are likely to exceed this threshold.

Identify whether your counterparties are caught

Reg IM only needs to be posted if **both parties** are caught by Phase 6. You can check if your counterparties are caught by viewing their ISDA self-disclosure letter or carrying out your own outreach. You will also need to complete an ISDA self-disclosure letter if you have not already done so. Almost all sell-side entities are likely to be caught. If neither they nor you are UK/EU, however, these particular rules will not apply, though equivalents in other jurisdictions may.

Calculate your collateral posting requirements

- **Calculation methodology:** two methodologies are available: (i) **“grid”** – set out in the Margin RTS under UK and EU margin rules; or (ii) **ISDA SIMM** (which generally results in lower margin requirements).
- **Threshold:** Reg IM only needs to be posted in excess of €50m (i.e. if Reg IM = €53m, only €3m needs to be posted)³. If a trading relationship typically involves a Reg IM requirement of materially less than €50m, then putting segregated IM structures in place may not be necessary; you and your counterparty will need to keep this closely monitored.
- **Transaction pool:** Reg IM must be posted in respect of all new uncleared OTC derivatives traded on or after 1 September 2022 except:
 - physically-settled FX forwards and FX swaps;
 - principal payments on currency swaps;
 - covered bond transactions;
 - certain intragroup transactions (if exception criteria are fulfilled);
 - equity options (until 4 January 2024); and
 - certain physically-settled commodity forwards and options.
- **Collateral types:** the UK/EU margin rules stipulate a broad range of permitted eligible collateral and relevant credit quality criteria, haircuts and concentration limits. It is most efficient to agree eligible collateral directly with your counterparty at an operational level separate from the negotiation of the collateral documents. The broader the range of collateral, the longer it takes to align.

¹ This document covers only UK/EU margin rules.

² As defined in the UK/EU margin rules – see our note on **EMIR Refit** for further detail.

³ Threshold is calculated across all group entities.

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Identify and engage with your relevant service providers

Hold-ups are most likely to occur in establishing the requisite custody arrangements with third party providers – discussions need to start as soon as possible ahead of engaging on the collateral documentation.

- **Separate posting legs:** Reg IM must be posted separately by both parties on a segregated basis. Reg IM may not be reused or rehypothecated or repledged. This means you must appoint your own custodian (which can be different from your counterparty's custodian) to hold the collateral posted by you. Your posting leg will be documented separately from your counterparty's posting leg.
- **Service providers:** consider which service providers you will need engage and how the relationship will be documented – in particular:
 - Who will be your custodian?⁴
 - Are you comfortable with your counterparty posting via Euroclear or Clearstream? This will be the default choice for most of the buy-side. If you are, do you need to appoint a representative?⁵
 - If you have an existing collateral manager, does their role need to be extended to cover Reg IM posting?
- **Tri-party vs third party:** certain custodians offer a “tri-party” service which includes extra services such as collateral valuation and automatic moving of collateral. Under a standard “third party” service, you must direct the custodian manually to take action in respect of the collateral. Tri-party is more expensive than third party.
- **Account Control Agreements:** you will need to sign a separate account control agreement (ACA) with your custodian that complies with the segregation requirements stipulated by the UK/EU margin rules. Most custodians have template ACAs which they have agreed with ISDA for this purpose; you should ask your custodian for their agreed form of ACA and review it. Bear in mind that deviations from the agreed ISDA form may be resisted by bank counterparties on grounds of limited capacity.
- **Legal review of segregation arrangements:** the UK/EU margin rules oblige counterparties to perform an independent legal review of the segregation arrangements of their custodian to ensure they comply with the relevant requirements. You should start forming a view on how you will satisfy this obligation.
- **Points for asset managers**
 - Where you act for multiple funds trading under an umbrella ISDA which are not all under your direct control, consider whether you will impose one custodian on all funds under the same umbrella, or whether you will allow individual funds to select their own custodian and how such custody arrangements will be documented. In some circumstances it may be possible to set up umbrella custody arrangements, however we anticipate it will be simpler (and more consistent with the segregation requirements) to document each custody arrangement separately.
 - **Multi-managed funds**
 - » Funds may trade with their counterparties via more than one manager. In these circumstances the threshold and minimum transfer amount (MTA) stipulated by the UK/EU margin rules applies across all managers in aggregate and the fund will need to decide how to allocate the threshold and MTA between each manager.
 - » Multi-managed funds may wish to appoint one custodian to hold all Reg IM posted to the same counterparty via different managers – if so, imposing one custodian on all funds sitting under the relevant umbrella ISDA may not be possible (see bullet point above).

⁴ Note that the governing law of the document creating security over the collateral account needs to match the jurisdiction where the collateral account is located. If you are considering using a custodian located in England or New York and documenting the security interest under an ISDA IM CSD (for English law) or an ISDA IM CSA (for NY law), you should also check the relevant governing law of your ISDA to ensure there is no mismatch.

⁵ Ideally your custodian would also act as your representative on Euroclear and Clearstream.

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At a minimum, for each posting leg you will need to negotiate and sign:

Document	Parties	Comments
Collateral documentation		Bilateral IM NY law CSA or English law CSD covering both posting legs ⁶
Posting leg	You	Collateral Transfer Agreement and Security Agreement ⁷
	Counterparty	
Receiving leg		Collateral Transfer Agreement and Security Agreement ⁸
Account control agreement	You	Form provided by the custodian. Control and access provisions must reflect the segregation requirements under the relevant margin rules
	Counterparty	
	Custodian	
Eligible collateral schedule	You	Agreed directly between the parties
	Counterparty	
Custody agreement	You	Likely already in place, must ensure it will extend to Reg IM
	Custodian	
Euroclear/Clearstream representative agreement	You	Only necessary if Counterparty posts via Euroclear/Clearstream
	Relevant representative	

⁶ Relevant if posted collateral is held in UK or NY.

⁷ Relevant if posted collateral is held outside the UK or is at Euroclear/Clearstream.

⁸ Relevant if posted collateral is held outside the UK or is at Euroclear/Clearstream.

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