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Client Alert Commentary

Latham & Watkins Derivatives Practice

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ESMA Publishes Draft Regulatory Technical Standards on Cross-border Application of EMIR

Parties engaged in derivative contracts should review and comment on these proposed standards by 16 September 2013.

On 17 July 2013, the European Securities and Markets Authority (ESMA) published a Consultation Paper that sets out the draft Regulatory Technical Standards on contracts having a direct, substantial and foreseeable effect within the Union and non-evasion of provisions of EMIR (Draft Cross-border RTS). The Consultation Paper sets out ESMA's proposal with respect to secondary regulation that clarifies remaining open issues regarding cross-border application of Regulation (EU) No 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories (EMIR).

EMIR entered into force on 16 August 2012. However, application of those requirements imposed by EMIR that need to be further developed by way of regulatory technical standards has been delayed until the date on which such standards take effect. EMIR explicitly addresses cross-border application of the clearing obligation (set out in Article 4) and the risk-mitigation techniques (set out in Article 11). In both instances, certain aspects of the cross-border application of these requirements are left to be developed by way of regulatory technical standards to be prepared by ESMA. EMIR imposed 30 September 2012 as the deadline by when ESMA was required to submit a draft of these standards to the European Commission. However, the process proved to be significantly more complex, involving a certain level of co-ordination with regulators in other jurisdictions (in particular US). The European Commission therefore extended the deadline to 25 September 2013, which is the main reason why it is only now that ESMA is addressing these issues for the first time.[1]

The Consultation Paper is open for comments until 16 September 2013. At the end of the consultation period, ESMA will consider all submissions and send the final report to the European Commission to allow the European Commission to adopt the Draft Cross-border RTS (either in the current or an amended form). Once adopted, the relevant obligations to comply with the EMIR requirements in the cross-border context will become effective.

Overview

Title II of EMIR does not distinguish between "entity-level" and "transaction-level" requirements, as most of the requirements set out therein are drafted to apply to derivative contracts rather than to certain types of entities engaged in entering into derivative contracts. The definition of "derivative contract" was not developed specifically for EMIR purposes but rather incorporated from the existing definition of financial instruments set out in points (4) to (10) of Section C of Annex I to Directive 2004/39/EC (MiFID) as implemented by Articles 38 and 39 of Regulation (EC) No 1287/2006. "Derivative contract" covers a

broad range of financial instruments, including options, futures, swaps, forwards and other derivatives relating to securities, currencies, interest rate, financial indices, credit risk and certain commodity and other derivatives.

When considering cross-border application of the clearing and risk mitigation requirements set out in Articles 4 and 11, one has to therefore identify which derivative contracts will be subject to such requirements (rather than focusing on whether certain activities of market players engaging in trading in derivatives may have a significant effect within the European Union). ESMA was tasked pursuant to EMIR to develop two tests to determine: 1) which derivative contract "has a direct, substantial and foreseeable effect within the European Union" and 2) where application of EMIR requirements to certain cross-border derivative contracts is "appropriate to prevent the evasion of EMIR".

Contracts between entities established in the European Union

There are two categories of counterparties to a derivative contract: 'financial counterparty' and 'non-financial counterparty'. Financial counterparty is defined by reference to several pre-existing categories of entities authorised in accordance with certain European Directives, including investment firms, credit institutions and alternative investment funds. [2] None of these categories were introduced by EMIR or created in the context of the regulatory overhaul of the derivatives space. As a result, an entity authorised pursuant to one of these European Directives will be subject to the clearing and risk mitigation requirements set out in Articles 4 and 11 if it enters into a derivative contract irrespective of the size of its derivative position or the volume or frequency of entering into such derivative contracts and regardless of where such entity is incorporated (whether within the European Union or in a third country). Non-financial counterparty is defined as an undertaking established in the Union other than central counterparties and the entities that fall under the category of financial counterparties.[3]

"Established" in the EU

In the context of the non-financial counterparties, it is therefore critical to determine the meaning of the word "established". While it is fairly clear that a corporation incorporated under the laws of one of the member states of the European Union will be considered to be "established" in the Union for the purposes of the definition of non-financial counterparty, it remains open whether certain other entities or natural persons would be treated as "established" in the Union for these purposes. The Draft Cross-border RTS does not address this open point.

Non-EU Branches of entities established in the EU

The European Commission has clarified, albeit in a different context, that third-country branches of EU entities are considered established in the EU.[4] Where two entities established in the EU enter into a derivative contract via their respective non-EU branches, such derivative contract would therefore be subject to the clearing and risk mitigation requirements set out in Articles 4 and 11.

Contracts between entities one of which is established in the European Union

When only one counterparty to a derivative contract is a financial counterparty or a non-financial counterparty established in the European Union and the other counterparty is established in a third country, EMIR allows in certain circumstances for substituted compliance with the requirements of such third country.

Equivalence decisions

In order for such substituted compliance to be available, the European Commission must adopt an implementing act declaring that the legal, supervisory and enforcement arrangements of such third country are equivalent to the requirements laid down in EMIR.[5] The purpose of such equivalence decision by the European Commission is to verify on an 'outcome-focused' basis that the supervisory framework of such third country delivers equivalent results. Any such equivalence decision must be reviewed at least on an annual basis to ensure that the equivalent requirements are properly supervised and enforced by third country authorities and can be withdrawn at any time. The European Commission requested ESMA to deliver technical advice with respect to equivalence of the following jurisdictions: US,[6] Japan (in the case of US and Japan, such technical advice must be provided by 1 September 2013), Australia, Canada, Hong Kong, India, Singapore, South Korea and Switzerland (in the case of the other jurisdictions set out above, the advice must be provided by 1 October 2013).[7]

Contracts between entities established in one or more third countries

The Draft Cross-border RTS clarifies in which circumstances the clearing and risk mitigation requirements set out in Articles 4 and 11 may apply in a scenario in which two entities established in a third country enter into a derivative contract.

There are two instances where ESMA expects to treat derivative contracts as having a direct, substantial and foreseeable effect within the European Union. First, ESMA focuses on the scenario where the obligations of at least one of the counterparties are guaranteed by an entity established in the EU, subject to certain de minimis thresholds set out below, and provided that the entity guaranteeing such obligations is a financial counterparty established in the EU.[8] Second, ESMA also expects to apply EMIR (subject to the carve-outs set out below) to derivative contracts entered into between the EU branches of two third country entities.

If, in any of the scenarios referred to above, at least one of the parties to such derivative contract is established in a jurisdiction that was declared to be equivalent pursuant to the equivalence decision of the European Commission described above, ESMA proposes to take into account the mechanism provided in Article 13 of EMIR allowing the counterparties to comply with the equivalent third country regulatory framework rather than with EMIR.

Guaranteed derivative contracts

Where two third country entities enter into a derivative contract and the obligations of at least one of the parties thereunder are guaranteed by a financial counterparty established in the EU, ESMA proposes to apply a de minimis test to determine whether such contract should be viewed as having a direct, substantial and foreseeable effect within the European Union. The test consists of two prongs: 1) does the notional amount of the guaranteed derivative contract(s) exceed EUR 8bn; and 2) does the value of the guaranteed obligations exceed 5 per cent. of the total OTC derivative exposure of the financial counterparty providing the guarantee. Exposure in this context should be measured similarly to how 'current exposure' is measured pursuant to the Capital Requirement Regulation.[9]

Prevention of Evasion

Where analysing an arrangement that avoids the application of EMIR, ESMA is proposing in the Draft Cross-border RTS to focus on the primary purpose of such arrangement or a series of arrangements, looking in particular for any hints of such arrangement being artificial (*i.e.*, lacking commercial substance or economic justification in itself). By way of example, ESMA refers to an arrangement that "is carried out in a manner which would not ordinarily be employed in what is expected to be a reasonable business

conduct"[10] as an arrangement that may be deemed artificial. The proposed test would be an objective test, where parties' subjective intentions will be disregarded.

ESMA gives two examples of evasion in the Consultation Paper: one being within a group where a derivative contract is entered into by an entity that is not involved in the business to which the derivative relates or in the risk management of the group and therefore such arrangement is not supported by any commercial, business or economic reason; the other example being a similar scenario but involving unrelated parties.

Conclusion

Appended to this Client Alert is a table showing our interpretation of ESMA's proposed application of EMIR to OTC derivative contracts in the cross-border context. Aside from the conclusions in the table, if an arrangement involving third country firms is seen as being entered into to evade the application of EMIR, such arrangement may be subject to EMIR as a result of the rules designed to prevent such evasion.

We encourage clients to review first-hand the Draft Cross-border RTS and to provide comments to ESMA within the consultation period (ending on 16 September 2013).

If you have questions about this Client Alert or if you would like to discuss your concerns about the Draft Cross-border RTS, please contact one of the attorneys listed below or the Latham & Watkins lawyer with whom you normally consult:

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Endnotes

[1] The publication of the Consultation Paper follows shortly after the Commodity Futures Trading Commission (CFTC) approved its final interpretative guidance regarding the cross-border application of its rules under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

[2] *See* Article 2(8) of EMIR: 'financial counterparty' means an investment firm authorised in accordance with Directive 2004/39/EC, a credit institution authorised in accordance with Directive 2006/48/EC, an insurance undertaking authorised in accordance with Directive 73/239/EC, an assurance undertaking authorised in accordance with Directive 2002/83/EC, a reinsurance undertaking authorised in accordance with Directive 2005/68/EC, a UCITS and, where relevant, its management company, authorised in accordance with Directive 2009/65/EC, an institution for occupational retirement provision within the meaning of Article 6(a) of Directive 2003/41/EC and an alternative investment fund managed by AIFMs authorised or registered in accordance with Directive 2011/61/EC.

[3] *See* Article 2(9) of EMIR.

[4] *See* Answer to question III.3 in EMIR: Frequently Asked Questions at: http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/emir-faqs_en.pdf

[5] *See* Article 13(2) of EMIR.

[6] With respect to US, it is worth noting that the European Commission has recently stated in a press release co-ordinated with a CFTC press release that the "EU and US rules for risk mitigation are essentially identical", *see*: http://europa.eu/rapid/press-release_MEMO-13-682_en.htm

[7] The original request of the European Commission included also a reference to Dubai as one of the jurisdictions to be analysed. Dubai has, however, now been withdrawn while South Korea has been added to the initial list.

[8] It is not clear whether the reference to "a financial counterparty established in the Union" in Article 2(2) of the Draft Cross-border RTS is meant to be read as introducing a sub-category of 'financial counterparties' defined in Article 2(8) of EMIR.

[9] *See* Article 272(17) of Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (the "**Capital Requirement Regulation**") that defines 'current exposure' as 'the larger of zero and the market value of a transaction or portfolio of transactions within a netting set with a counterparty that would be lost upon the default of the counterparty, assuming no recovery on the value of those transactions in insolvency or liquidation'.

[10] *See* Article 3(b) of the Draft Cross-border RTS.

ESMA's proposed application of EMIR to OTC derivative contracts in the cross-border context

Derivative contract entered into between:	**EU firm (including branches in third countries)**	**Third country firm (equivalent jurisdiction), no guarantee***	**EU branch of third country firm (equivalent jurisdiction)**	**Third country firm (equivalent jurisdiction) with guarantee* from EU financial counterparty**	**Third country firm (non-equivalent jurisdiction), no guarantee***	**EU branch of third country firm (non-equivalent jurisdiction)**	**Third country firm (non-equivalent jurisdiction) with guarantee* from EU financial counterparty**
EU firm (including branches in third countries)	EMIR applies	Substituted compliance permitted	Substituted compliance permitted	Substituted compliance permitted	EMIR applies	EMIR applies	EMIR applies
Third country firm (equivalent jurisdiction), no guarantee*	Substituted compliance permitted	EMIR does not apply	EMIR does not apply	Substituted compliance permitted	EMIR does not apply	EMIR does not apply	Substituted compliance permitted
EU branch of third country firm (equivalent jurisdiction)	Substituted compliance permitted	EMIR does not apply	Substituted compliance permitted	Substituted compliance permitted	EMIR does not apply	Substituted compliance permitted	Substituted compliance permitted
Third country firm (equivalent jurisdiction) with guarantee* from EU financial counterparty	Substituted compliance permitted	Substituted compliance permitted	Substituted compliance permitted	Substituted compliance permitted	Substituted compliance permitted	Substituted compliance permitted	Substituted compliance permitted
Third country firm (non-equivalent jurisdiction), no guarantee*	EMIR applies	EMIR does not apply	EMIR does not apply	Substituted compliance permitted	EMIR does not apply	EMIR does not apply	EMIR applies
EU branch of third country firm (non-equivalent jurisdiction)	EMIR applies	EMIR does not apply	Substituted compliance permitted	Substituted compliance permitted	EMIR does not apply	EMIR applies	EMIR applies
Third country firm (non-equivalent jurisdiction) with guarantee* from EU financial counterparty	EMIR applies	Substituted compliance permitted	Substituted compliance permitted	Substituted compliance permitted	EMIR applies	EMIR applies	EMIR applies

* *References in the table above to a guarantee mean a guarantee given by an EU financial counterparty that is over the thresholds specified in the Draft Cross-border RTS.*