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Cross-Border RTS Starts Countdown for EMIR Obligations for Non-EU Counterparties

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OTC derivative contracts which have a counterparty located outside of the European Union ("**EU**") may now be subject to the requirements of the European Market Infrastructure Regulation[1] ("**EMIR**").

Yesterday, twenty days after the publication of Commission Delegated Regulation (EU) No 285/2014 supplementing EMIR (the "**Cross-Border RTS**")[2] in the Official Journal of the EU, the rules concerning the extraterritorial jurisdiction of EMIR entered into force. These rules specify the OTC derivative contracts which shall be considered to have a "direct, substantial and foreseeable" effect in the EU and those which shall be deemed to have been designed to circumvent the application of EMIR rules and obligations.[3]

Implementation

Articles 4(4) and 11(14) of EMIR require the European Securities and Markets Authority ("**ESMA**") to draft second-level regulatory technical standards ("**RTS**") to define the OTC derivative contracts that have a "direct, substantial and foreseeable" effect in the EU and, therefore, will be subject to EMIR. ESMA is also required to draft RTS that specify the cases whether the imposition of EMIR's obligations is necessary or appropriate to prevent the evasion of its rules or obligations. The original consultation paper for this RTS was published by ESMA on 17 July 2013 (*see* 12 August 2013 C&F Memo). After the consultation period ended on 16 September 2013, ESMA published its final guidance to the European Commission on 15 November 2013.[4]

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1 Regulation (EU) No. 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories, OJ L 201, 4.7.2012, pp. 1-59.

2 Cross-Border RTS, OJ L 85, 21.3.2014, pp. 1-3.

3 EMIR was adopted on 4 July 2012 and entered into force on 16 August 2012. EMIR sets out the EU commitments made in international forums like the G20 to diminish the effects of the financial crisis and mitigate risks in OTC derivatives markets.

4 ESMA/2013/1657, Final Report, *Draft technical standards under EMIR on contracts with a direct, substantial and foreseeable effect within the Union and non-evasion* (15 November 2013).

The Cross-Border RTS was published in the Official Journal on 21 March 2014 and came into force on 10 April 2014. However, it incorporates a six-month delay in its extraterritorial application so that third-country counterparties have sufficient time to meet the terms of other EMIR obligations, including clearing, registration and risk management.

The Cross-Border Application of EMIR

The European Parliament and the Council explicitly require an extraterritorial application of EMIR to all OTC derivative contracts which have a "direct, substantial and foreseeable effect" in the EU as well as those which are designed to evade the regulation.

The Cross-Border RTS sets out two circumstances where an OTC derivative contract will be considered to have a direct, substantial and foreseeable effect in the EU.

The first circumstance is based upon the guarantor of the third-country entity. An OTC derivative contract is subject to EMIR when a third-country counterparty is guaranteed by an EU entity which:

1. covers the third-country entity for at least EUR 8 billion; and
2. is equal to at least five percent of the sum of current exposures of the issuer of the guarantee.

The Cross-Border RTS definition of "guarantee" requires "an explicitly documented legal obligation" [5]and, therefore, excludes any implicit guarantees. Contracts of insurance and credit derivatives are outside the scope of the definition.

Separate from the issuance of a guarantee, the second circumstance where an OTC derivative contract is said to have a "direct, substantial and foreseeable effect" in the EU is when two third-country counterparties enter into the contract through their branches in the EU "and such counterparties would qualify as financial counterparties if they were established in the Union."[6]

Non-Evasion Provisions of EMIR

An OTC derivative contract that, as its primary purpose, is designed to evade the application of any provision of EMIR nevertheless will be subject to the regulation. This includes any artificial arrangements or series of arrangements. ESMA adopted a criteria-based approach to this rule[7] rather than create a list of circumstances or examples that would represent the evasion of EMIR.

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[5] Cross-Border RTS, p.2.

[6] *Id.*, p. 3.

[7] ESMA/2013/1657, p. 12. *See also* Cross-Border RTS, Recital 1, p. 1.

Practical Application

ESMA's final guidance to the European Commission clarifies that there is no historical obligation with regards to the extraterritoriality application.[8] Only contracts which remain outstanding on the date of its entry into force are subject to the Cross-Border RTS. All other contracts concluded before that date are not considered to have a direct, substantial and foreseeable effect in the EU.

In order to prevent "duplicative or conflicting rules,"[9] ESMA clarifies in its final guidance to the European Commission that "when one of the third-country counterparties is established in an equivalent country, both counterparties will be deemed to have fulfilled obligations under EMIR."[10] Thus, if an implementing act has been adopted declaring a third-country regime as "equivalent" to EMIR, the Cross-Border RTS will not apply. To date, there are no implementing acts which would satisfy this exemption.

Going forward, all third-country counterparties should take a careful consideration of the new rule as they enter into derivative contracts. Over the next six months, it is important to identify counterparties that may have an EU guarantor and be conscious of circumstances where day-to-day business will trigger the application of EMIR by virtue of this RTS.

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Please feel free to contact any of the following Cadwalader lawyers if you have any questions about this Clients & Friends Memo.

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8 ESMA/2013/1657, p. 11.

9 EMIR, Article 13.

10 ESMA/2013/1657, Recital 19, p. 7. *See also* Cross-Border RTS, Recital 2, p. 1.