Clients&FriendsMemo

ESMA Consults on the Extra-Territorial Application of EMIR

12 August 2013

On 17 July 2013, the European Securities and Markets Authority (**"ESMA"**) published a consultation paper (the **"Consultation Paper"**)[1] on draft regulatory technical standards (**"RTS"**) aimed at implementing certain provisions of the European Markets Infrastructure Regulation[2] (**"EMIR"**) relating to (a) the extraterritorial application of EMIR, and (b) preventing the evasion of EMIR's provisions.

Background

EMIR was adopted on 4 July 2012 and entered into force on 16 August 2012. EMIR introduces provisions to improve transparency, establish common rules for central counterparties and for trade repositories and to reduce the risks associated with the OTC derivatives market. In particular, EMIR provides for obligations to centrally clear OTC derivative contracts and to apply risk mitigation techniques to uncleared swaps such as the exchange of collateral. These obligations apply in a variety of circumstances including in respect of certain OTC derivative contracts between two entities established in one or more third countries that would be subject to the clearing obligation if they were established in the EU, provided that the contract has "a direct, substantial and foreseeable effect within the [EU]" or where "such an obligation is necessary or appropriate to prevent the evasion of any provisions of [EMIR]"[3].

Article 4(4) of EMIR requires ESMA to develop draft RTS specifying the contracts that are considered to have a direct, substantial and foreseeable effect within the EU and the cases where it is necessary or appropriate to prevent the evasion of any provision of EMIR. The draft RTS have been developed against the backdrop of the ongoing process of recognition of "equivalence"[4] under which the requirements of EMIR can be dis-applied where at least one of the counterparties is located in a third country where the legal, supervisory and enforcement arrangements of that third country are declared equivalent.

1 http://www.esma.europa.eu/system/files/2013-892_draft_rts_of_emir.pdf

2 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF

3 See Article 4(1)(a)(v) and Article 11(12) of EMIR

4 See Article 13 of EMIR

Direct, substantial and foreseeable effect within the EU

Guarantees
ESMA has taken the view that where an OTC derivative contract is entered into by a third country counterparty benefiting from a guarantee issued by an EU guarantor, the OTC derivative contract would have a direct effect in the EU – that is, where the guarantor is established.

However, ESMA proposes limiting the scope of guarantee arrangements which would have a direct effect in the EU to those:

- issued by EU-established financial counterparties[5];
- that both:
  - reach or exceed a significant monetary value (in this regard, ESMA has proposed a threshold of €8bn of gross notional amount of OTC derivatives); and
  - are considered significant in the context of the overall activity of the EU established guarantor (in this regard, ESMA has proposed a threshold of 5% of the OTC derivatives exposures of the EU established financial counterparty).

EU branches of third country entities
The Consultation Paper also considers whether transactions between EU branches of third country entities would have a direct effect on European markets. In this regard, ESMA proposes that[6]:

- transactions between two EU branches of two non-EU entities should be said to have a direct, substantial and foreseeable effect within the EU and should therefore be subject to the requirements of EMIR; *but*
- transactions between the EU branch of a non-EU entity and a non-EU branch of a non-EU counterparty should not be said to have a direct, substantial and foreseeable effect within the EU and should therefore not be subject to the requirements of EMIR.

Subsidiaries
The Consultation Paper also considers whether OTC derivative contracts entered into by third country subsidiaries of an EU parent could have an effect on the EU parent and therefore be said to have a direct, substantial and foreseeable effect within the EU. ESMA considers that any effect on the EU parent cannot be said to be "direct and foreseeable" noting that the parent

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5 ESMA is of the view that (a) guarantees issued by entities other than financial counterparties are not expected to be substantial; (b) competent authorities have less information on guarantees issued by entities other than financial counterparties; and (c) competent authorities should have the appropriate powers to enforce the provisions of the RTS and these powers are well developed for financial counterparties

6 ESMA also notes that transactions between the EU branch of a non-EU entity and an EU counterparty are dealt with under other provisions of EMIR and are outside the scope of the Consultation Paper

would not be legally bound by the OTC derivative contracts of its subsidiaries, unless it has issued guarantees in this respect (case already covered above).

Factors that will not be taken into consideration
ESMA considered whether a counterparty established in a third country listing an entity established in the EU for the purpose of acceleration or cross-default in their ISDA Master Agreement may have an effect within the EU. For example, a counterparty established in a third country may designate an entity established in the EU as a Specified Entity pursuant to an ISDA Master Agreement. However, ESMA noted that the effect of default by the Specified Entity does not impact the parties to the obligation or the obligation itself but only the timing of the obligation and that the transaction and resulting liabilities remain between the counterparties. ESMA concluded that it would be disproportionate to include in the scope of EMIR transactions where the only nexus with the EU was a Specified Entity established in the EU.

In addition, ESMA considered whether the currency of the underlying OTC derivative contract would be relevant in determining whether a contract has a "direct, substantial and foreseeable effect within the EU" and concluded that it would not.

Prevention of evasion

ESMA proposes developing a set of criteria to look to the substance or economic effect of a transaction as opposed to its legal form to determine whether a particular OTC derivative contract should be captured by EMIR. In particular, ESMA proposes to adopt an approach which is similar to the approach taken in tax evasion legislation, taking into account (i) whether the legal characterisation of the individual steps is inconsistent with the legal substance of the arrangement as a whole, (ii) whether the arrangement is carried out in a manner which would not ordinarily be employed in what is expected to be reasonable business conduct; (iii) whether there are elements which have the effect of offsetting or cancelling the economic meaning of each other and (iv) whether the transactions concluded are circular in nature.

ESMA proposes that if a global arrangement has a business, commercial or economic justification, it would be legitimate. As un-exhaustive examples of avoidance, ESMA has listed (i) where an entity in a group, B, incurs the risk, but the hedging is done by another entity, A, that is not involved in the business to which the derivative relates, or (ii) an entity, B, incurs the risk but agrees with a non-related party, A, that a party, D, which is not subject to EMIR, will enter into a derivative contract.

Commentary

The clearing obligation and risk mitigation techniques under EMIR apply to certain transactions entered into by third-country counterparties. The draft RTS bring some clarity to determining what would constitute a "direct, substantial and foreseeable effect". However, it should be noted that there is no common methodology to calculate the thresholds used to determine whether an OTC derivative contract entered into by third country counterparties benefiting from a guarantee issued by an EU guarantor would be subject to EMIR[7]. It should also be noted that ESMA intends to capture other arrangements that operate "in a substantially similar way" to guarantees. Therefore care should be taken when other instruments, such as monoline protection (financial guarantees), letters of credit or performance bonds are used.

ESMA will consider comments on the Consultation Paper received by 16 September 2013.

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[7] ESMA has proposed using the definition of current exposure provided in Art. 272(17) of the Capital Requirements Regulation: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32013R0575:EN:NOT