MEMO# 27564

September 16, 2013

ICI and ICI Global Submit Comment Letter on Proposed Draft Standards for Derivatives Contracts between Non-EU Entities Potentially Subject to EU Regulations

[27564]

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 79-13
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 70-13
ICI GLOBAL MEMBERS
INTERNATIONAL MEMBERS No. 45-13 RE: ICI AND ICI GLOBAL SUBMIT COMMENT LETTER ON PROPOSED DRAFT STANDARDS FOR DERIVATIVES CONTRACTS BETWEEN NON-EU ENTITIES POTENTIALLY SUBJECT TO EU REGULATIONS

ICI and ICI Global submitted a letter to the European Securities and Markets Authority ("ESMA") in response to a consultation paper specifying the circumstances in which derivatives transactions between two counterparties established outside the European Union ("EU") would be subject to the European Market Infrastructure Regulation ("EMIR"). [1] A copy of the letter is attached and summarized below.

The letter generally supports the approach taken by ESMA, which would circumscribe appropriately the application of EMIR to only those transactions between third-country entities with direct, substantial, and foreseeable effects within the European Union. The letter also provides some specific comments on the proposed draft standards.

Derivatives Contracts with Direct, Substantial, and Foreseeable Effects within the European Union

The letter shares ESMA's view that the criteria for determining when contracts entered into by two third country counterparties would be subject to certain requirements under EMIR should be clear and detailed to provide certainty. The letter generally supports the two situations in which an OTC derivatives contract between two non-EU counterparties may have a direct, substantial, and foreseeable effect within the European Union.

In the first situation, when an OTC derivatives contract is entered into by a third country counterparty benefiting from a guarantee issued by an EU guarantor, the OTC derivatives contract would have a direct effect in the European Union. ESMA limits the scope of this provision to guarantees issued by financial counterparties and for which the amount of the guarantee exceeds two thresholds related to the value of the OTC derivatives contract guaranteed and the value of the guarantee compared to the OTC derivatives activity of the EU financial counterparty providing the guarantee. [2] The letter explains, however, that a non-EU counterparty (such as a non-EU regulated fund) may not be aware of a counterparty's guarantee or whether the two thresholds have been reached. The letter, therefore, requests that ESMA permit non-EU counterparties to rely on representations by their counterparties that the transactions are not guaranteed by an EU financial counterparty or that the guarantee is below the two thresholds.

In the second situation, where two non-EU entities enter into an OTC derivatives contract and both entities act through a branch in the European Union, the contract would be subject to certain requirements under EMIR. The letter notes that the provision would not be relevant to regulated funds, which do not operate through branches.

Prevention of Evasion

EMIR includes anti-evasion rules designed to subject transactions entered into by counterparties established outside of the European Union to the clearing obligation and risk mitigation techniques required by EMIR where this is necessary or appropriate to prevent the evasion of EMIR. ESMA proposes that the key consideration is the primary purpose of the arrangement. If the arrangement is established because of a business or commercial reason or economic justification, ESMA would view it as legitimate.

The letter generally supports ESMA's key consideration but urges ESMA to adopt a principles-based approach for determining whether an arrangement is designed to evade the provisions of EMIR. The letter agrees with ESMA that it should not develop a prescriptive list of transactions or circumstances that would violate the anti-evasion rule. Therefore, the examples provided by ESMA of situations that would give rise to the application of the anti-evasion rule risk ESMA adopting an approach that it wishes to avoid, i.e., a prescriptive list of transactions or circumstances.

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Attachment

endnotes

[1] Draft Regulatory Technical Standards on Contracts Having a Direct, Substantial and Foreseeable Effect within the Union and Non-Evasion of Provisions of EMIR (July 17, 2013), available at http://www.esma.europa.eu/system/files/2013-892_draft_rts_of_emir.pdf ("Consultation Paper").   For a summary of the Consultation Paper, see ICI Memorandum No. 27396 (July 22, 2013), available at http://www.ici.org/my_ici/memorandum/memo27396.

[2] ESMA proposes to set the minimum threshold at €8 billion of gross notional outstanding (consistent with standards adopted by the Basel Committee on Banking Supervision and

IOSCO on margin for uncleared derivatives) and 5 percent of the total OTC derivatives exposures that the financial counterparty established in the European Union faces.
