

**MEMO# 27708**

November 19, 2013

# **ESMA Adopts Standards on Derivatives Contracts between Non-EU Entities Subject to EU Regulations**

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 93-13  
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 81-13  
INVESTMENT ADVISER MEMBERS No. 74-13  
ICI GLOBAL MEMBERS  
INTERNATIONAL MEMBERS No. 53-13  
SEC RULES MEMBERS No. 105-13 RE: ESMA ADOPTS STANDARDS ON DERIVATIVES  
CONTRACTS BETWEEN NON-EU ENTITIES SUBJECT TO EU REGULATIONS

On November 15, the European Securities and Markets Authority (“ESMA”) issued a final report that provides draft regulatory technical standards (“RTS”) regarding circumstances in which derivatives transactions between two counterparties established outside the European Union (“EU”) would be subject to the European Market Infrastructure Regulation (“EMIR”). [\[1\]](#) The RTS finalized by ESMA is substantially similar to those proposed in the Consultation Paper with some modifications in response to comments, including those of ICI. [\[2\]](#) The Final Report was submitted to the European Commission on the same day it was issued, and the Commission has three months to decide whether to endorse ESMA’s draft RTS.

In the RTS, ESMA specifies the conditions under which EMIR’s clearing obligation and risk mitigation requirements would apply to contracts between non-EU counterparties. These transactions between non-EU counterparties would be those that are considered to have a direct, substantial, and foreseeable effect within the European Union or situations where it is necessary or appropriate to prevent the evasion of any provision of EMIR. Article 13 of EMIR, however, provides a mechanism to avoid duplicative or conflicting rules by recognizing the equivalence of a foreign country’s regulatory framework. Accordingly, if one of the two counterparties to a transaction is established in a third country, the regulatory framework of which the EU Commission has declared equivalent, both counterparties will be deemed to have fulfilled obligations under EMIR by applying the equivalent rules of the third country. [\[3\]](#); The RTS, therefore, analyzes only those situations where both counterparties are established in non-equivalent jurisdictions.

## **Scope of Transactions with Direct, Substantial, and Foreseeable Effects within the European Union**

The RTS include two situations in which transactions between two non-EU counterparties may have a direct, substantial, and foreseeable effect within the European Union. First, when an over-the counter (“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. [\[4\]](#) The second situation involves transactions between two non-EU entities operating through EU branches.

In response to comments, ESMA made several modifications to the scope of transactions. First, in response to requests for clarification on the term “guarantee,” ESMA introduced a term in the RTS to provide legal certainty. The definition refers to explicitly documented legal obligations, thereby excluding implicit guarantees and in general “letters of comfort,” unless they are drafted as a legal obligation of the issuer. Credit derivatives and contracts of insurance also are outside the definition of guarantee. In addition, responding to comments that third country counterparties need time to prepare for compliance with the RTS, ESMA provides a six-month transition period. The RTS would apply six months after the date of entry into force of the Regulation adopting the draft RTS.

## **Scope of Application to OTC Derivatives Contracts**

In the RTS, ESMA clarifies that OTC derivatives contracts concluded before the date of application of the relevant part of the Regulation will not be considered as having a direct, substantial, and foreseeable effect within the European Union. Therefore, contracts concluded before the date of application of the RTS will not be subject to the application of the relevant provisions of EMIR. For the calculation of the €8 billion and 5% thresholds, all the relevant outstanding contracts should be considered even if concluded before the date of the application of the RTS.

## **Prevention of Evasion**

The RTS sets forth a set of criteria regarding the substance or effect of OTC transactions to prevent the evasion of EMIR. The anti-avoidance provision is to cover arrangement that have as a primary purpose the avoidance of application of EMIR. When a contract is concluded for commercial reasons, it will not have the evasion of EMIR as a primary purpose.

Commenters, including ICI, expressed concern that the examples of situations included in the RTS that would give rise to the application of the anti-evasion rule could create confusion and provide a prescriptive list of transactions or circumstances. In response, ESMA amended the text of the RTS to remove those examples.

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### **endnotes**

[\[1\]](#) Final Report, Draft Technical Standards under EMIR on Contracts with a Direct,

Substantial and Foreseeable Effect within the Union and Non-Evasion (Nov. 15, 2013), available at

[http://www.esma.europa.eu/system/files/2013-1657\\_final\\_report\\_on\\_emir\\_application\\_to\\_third\\_country\\_entities\\_and\\_non-evasion.pdf](http://www.esma.europa.eu/system/files/2013-1657_final_report_on_emir_application_to_third_country_entities_and_non-evasion.pdf) ("Final Report"). 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](http://www.ici.org/my_ici/memorandum/memo27396).

[2] For a summary of ICI and ICI Global's comment letter, see ICI Memorandum No. 27564 (Sept. 16, 2013), available at [http://www.ici.org/my\\_ici/memorandum/memo27564](http://www.ici.org/my_ici/memorandum/memo27564).

[3] ESMA has delivered to the Commission its advice on equivalence with respect to 9 countries, including the United States, which can be used by the Commission to adopt its decisions on equivalence in those countries. The Commission has not yet made those equivalence determinations.<sup>0</sup>;

[4] ESMA sets the minimum threshold at €8 billion of gross notional outstanding (consistent with the threshold for exemption from initial margin adopted by the Basel Committee on Banking Supervision and IOSCO for uncleared derivatives) and 5 percent of the total OTC derivatives exposures that the financial counterparty established in the European Union faces. To provide clarity regarding the monitoring of thresholds, the RTS has been amended, for guarantees below €8 billion, to state that monitoring should occur on the day the amount of the guarantee is increased. When the guarantee is above €8 billion but the liabilities resulting from the OTC derivatives contracts covered by the guarantee are below €8 billion or 5%, the conditions should be monitored on the day of the increase of the liability for the €8 billion threshold and on the month of the decrease of the sum of the current exposures for the 5% threshold.