

**MEMO# 27396**

July 22, 2013

## **ESMA Proposes Draft Standards on Derivatives Contracts between Non-EU Entities Potentially Subject to EU Regulations**

[27396]

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TO: CLOSED-END INVESTMENT COMPANY MEMBERS No. 63-13  
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 57-13  
ICI GLOBAL MEMBERS  
INVESTMENT ADVISER MEMBERS No. 51-13  
INTERNATIONAL MEMBERS No. 33-13  
SEC RULES MEMBERS No. 70-13 RE: ESMA PROPOSES DRAFT STANDARDS ON DERIVATIVES CONTRACTS BETWEEN NON-EU ENTITIES POTENTIALLY SUBJECT TO EU REGULATIONS

On July 17, 2013, the European Securities and Markets Authority (“ESMA”) issued a consultation paper to specify circumstances in which derivatives transactions between two counterparties established outside the European Union (“EU”) would be subject to the European Market Infrastructure Regulation (“EMIR”). [\[1\]](#) Comments on the Consultation Paper are due by September 16. ESMA must submit final standards to the European Commission by September 25, 2013.

In the Consultation Paper, 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, EMIR would not apply even though the transaction would have a direct, substantial and foreseeable effect in the European Union. The Consultation Paper, therefore, analyzes only those situations where both counterparties are established in non-equivalent jurisdictions.

[\[2\]](#)

The Consultation Paper does not address situations in which one counterparty is established in the European Union and the other counterparty is established in a third country. In such a situation, the clearing obligation and risk mitigation requirements would apply. To avoid duplicative or conflicting rules, however, a finding of equivalence may be made under Article 13, as described above.

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

ESMA provides 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. [\[3\]](#)

The second situation involves transactions between two non-EU entities (of non-equivalent third countries) operating through EU branches. ESMA states that, because of the potential impact for the European Union from the failure of an entity with such significant interconnectedness of EU counterparties and markets, it does not propose any quantitative thresholds for these transactions. Conversely, ESMA believes that OTC derivatives contracts between an EU branch of a non-EU entity and another non-EU entity should be subject to the regime(s) of the third countries involved, rather than EMIR.

Finally, ESMA describes certain other criteria that it determined would not have a direct effect within the European Union, although it requests comment on whether it should consider these criteria. ESMA considered using the currency of the OTC derivatives contracts as well as the “underlying” of the OTC derivatives contracts to identify the direct, substantial and foreseeable effect of a contract within the European Union. ESMA, however, rejected using this type of criteria because it would result in too broad of a definition of the “direct” nature of the effect within the European Union. In addition, ESMA determined not to include derivatives contracts entered into by subsidiaries of an EU parent company that were established in a third country because it does not consider the effects of these transactions to be direct and foreseeable. Finally, ESMA also determined not to include transactions between third country entities that have derivative master agreements listing entities within their corporate groups (which may include an EU entity).

### **Prevention of Evasion**

ESMA proposes a set of criteria regarding the substance or effect of OTC transactions to prevent the evasion of EMIR. ESMA proposes to consider the global form of the arrangement or arrangements instead of focusing only on an individual OTC derivative contract to determine the primary purpose of the arrangement. If the arrangement is set up because of a business or commercial reason or economic justification, ESMA would view it as legitimate. In the absence of such a rationale, ESMA would consider such an arrangement to be artificial and states that it may give rise to “characterization as a case where evasion should be prevented.” In determining whether the arrangement or series of arrangements is artificial, ESMA would look to one or more of the following factors: (1) whether the legal characterization of the individual steps of an arrangement is inconsistent with the legal substance of the arrangement as a whole; (2) whether the arrangement or

series of arrangement is carried out in a manner which would not ordinarily be employed in what is expected to be a reasonable business conduct; (3) whether the arrangement or series of arrangements includes elements which have the effect of offsetting or cancelling the economic meaning of each other; (4) whether transactions concluded are circular in nature; and (5) whether the arrangement or series of arrangements results in non-application of EMIR but is not reflected in the business risks undertaken by the entities relating to this activity.

Jennifer S. Choi  
Senior Associate Counsel – Securities Regulation

#### **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](http://www.esma.europa.eu/system/files/2013-892_draft_rts_of_emir.pdf) (“Consultation Paper”).

[2] In June, the EU Commission extended the deadline for its requested advice from ESMA regarding equivalence between certain third country legal and supervisory frameworks and EMIR. The new deadline for advice begins on September 1, 2013 with the United States and Japan. Letter from Emil Paulis, Director, Directorate G – Financial Markets, to Steven Maijor, Chair, ESMA, dated June 13, 2013, available at [http://www.esma.europa.eu/system/files/2013\\_14\\_june\\_2013\\_letter\\_esma.pdf](http://www.esma.europa.eu/system/files/2013_14_june_2013_letter_esma.pdf). If the regulatory framework of a third country, for example the United States, is determined by the EU Commission to be equivalent to those of EMIR, counterparties would be deemed to comply with the clearing obligation and risk mitigation requirements in EMIR by complying with the third country regulations. Deadline for advice on Australia, Canada, and Hong Kong is October 1, 2013.

[3] ESMA proposes to set the minimum threshold at €8 billion of gross notional outstanding (consistent with the proposal 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.