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ESMA Consults on Extraterritoriality

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The extraterritorial effect of new financial regulation is a controversial issue, fundamental to the business of banks, brokers, funds and their clients. A consultation paper containing proposed rules on certain extraterritorial issues arising out of the European Market Infrastructure Regulation (EMIR) was recently published. On the whole, it does not amount to a 'territory grab'. For derivative trades, non-EU entities guaranteed by EU entities or transacting through EU branches will fall within the scope of EMIR. Further details of the proposed new rules are set out below.

Extraterritoriality

Under EMIR, over-the-counter ("OTC") trades executed outside the EU are already subject to "extraterritorial" clearing, reporting and risk-mitigation requirements[1] when one party is established in the EU and the other is not. Such requirements necessitate clearing, reporting and risk mitigation by the EU counterparty, but non-EU counterparties will be affected indirectly due to their EU counterparty's regulatory obligations, because it is not possible to clear or report only half a transaction.

EMIR also purports to regulate trades entered into between two non-EU entities having a "direct, substantial and foreseeable effect" within the EU or where necessary to guard against evasion by non-EU entities of the EMIR requirements. Since the publication[2] of EMIR in July 2012, an indication from ESMA as to how restrictively the rules might be formed on this issue has been hotly anticipated. The draft ESMA[3] technical standards have not gone as far as some had feared. For example, jurisdiction is not being asserted based on product characterisation. There had been some market speculation that any derivative settling in or referencing European currencies, issuers, commodity standards or rate

1 Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories ("EMIR").

2 L 201/1, Official Journal of the European Union, 27 July 2012.

3 European Securities and Markets Authority Consultation Paper, 17 July 2013.

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standards could have been designated as having an "effect" in the EU, but this will not be the case.

Contracts with a Direct, Substantial or Foreseeable Effect within the EU

It is proposed that EMIR's clearing and risk mitigation requirements, though not its reporting requirements, will apply to transactions between non-EU established entities when rules in both jurisdictions are not considered to be equivalent to EMIR and either: (a) one of the counterparties is guaranteed, above certain thresholds, by an EU financial counterparty; or (b) both counterparties execute the transaction via their EU branches.

Under the draft standards, an OTC derivative contract will have a "direct, substantial or foreseeable effect" within the EU if one of the two following conditions is met.

Guarantee from an EU Financial Counterparty

At least one counterparty has a legally enforceable guarantee from a financial counterparty established in the EU. The guarantee must cover either all or part of its liability under the OTC derivative contract (with an aggregated notional amount of at least €8 billion equivalent). The guaranteed exposure must also be at least equal to five percent of the sum of current exposures for OTC derivative contracts of the EU financial counterparty issuing the guarantee. In order for EMIR to apply, the scope of the guarantee may therefore be general, covering all liabilities up to a certain amount, or specific, covering liabilities only from particular activities or derivatives contracts.

ESMA has proposed excluding guarantees issued by entities that are not "financial counterparties", so group guarantees within non-financial corporates will not be caught.

EU Branch

Mandatory clearing and risk mitigation will apply where two counterparties established in non-equivalent non-EU countries enter into an OTC derivative contract via their branches in the EU. ESMA's rationale is that the non-application of rules equivalent to EMIR for transactions concluded by EU branches of non-EU entities could result in market disruption. Such disruption could be a direct, substantial and foreseeable effect in the EU, regardless of the value of the contracts; which is why no quantitative thresholds have been applied.

The table below, adapted from ESMA's consultation paper, clarifies further when the obligations under EMIR and the draft standards apply.

Scope of Application of EMIR to Third Country Entities under the Draft Regulatory Technical Standards and Article 13 of EMIR:

		EU Entity (including Branches established in Third Countries)	Equivalent Third Country (including Branches established in Third Countries)	Non-Equivalent Third Country	
				EU Branch	**Third Country Entity**
EU Entity (including Branches established in Third Countries)		Clearing, reporting and risk mitigation required	Clearing, reporting and risk mitigation not required ('deemed' to be complied with)	Clearing, reporting and risk mitigation required	Clearing, reporting and risk mitigation required
Non-Equivalent Third Country	**EU Branch**	Clearing, reporting and risk mitigation required		Clearing and risk mitigation required	
	Third Country Entity	Clearing, reporting and risk mitigation required		Clearing and risk mitigation required only if substantial guarantee from EU Financial Counterparty	

As can be seen from the table above, EMIR applies more restrictively for EU entities, less restrictively for non-equivalent third country entities transacting through EU branches and even less so for non-equivalent third country entities not operating through EU branches. It remains to be seen whether this is reflected in the regulatory technical standards, once adopted.

Preventing the Evasion of EMIR

The draft standards contain anti-evasion provisions requiring business substance and economic justification for OTC derivative transactions to be booked in particular legal entities. These provisions apply when the contracts would have been subject to clearing or risk mitigation obligations but were created to evade these obligations. ESMA will view the conclusion of a contract as a whole to determine whether its primary purpose is the avoidance or abuse of the application of any part of EMIR. Any artificial arrangements, or series of such arrangements, with this purpose will therefore be caught. 'Artificial' is defined as lacking commercial substance or relevant economic justification in itself. ESMA, in deciding whether an arrangement is artificial, will consider: any inconsistency between the legal characterisation of the arrangement and its legal substance; any manner of conduct not amounting to reasonable business conduct; different elements offsetting each other's economic meaning; circular transactions; and arrangements to which EMIR does not apply but where this is not reflected in the business risks undertaken by the entities involved. It is suggested that tax law jurisprudence would be relevant here.

Conclusion and Next Steps

The European Commission and the US Commodity Futures Trading Commission ("CFTC") announced, on 11 July 2013, their agreed approach to cross-border derivatives for bilateral uncleared swaps and the trading execution requirement. The CFTC and European Commission have stated that they will continue to work together to reach consensus on margins for uncleared swaps, straight-through-processing, adoption of mandatory clearing obligations, regulating intragroup derivative trades, reporting requirements and CCP initial margin.

G20 finance ministers and central bank governors published a communiqué,[4] on 22 July 2013, regarding steps taken to ensure global consistency of rules. ESMA's relatively benign proposed rules on extraterritoriality are in the spirit of this communiqué considering the limited scope of its powers in this area.

ESMA will update the draft standards following a consideration of responses[5] to its consultation paper. It will then send its final report to the European Commission for endorsement. Organisations which previously considered themselves not subject to EU regulation should re-assess and consider whether any steps should be taken, either to avoid falling within the scope of the proposed rules or to comply with EMIR.

Dealers, funds and corporates should consider their most efficient business structures as the new rules, and equivalent US developments,[6] evolve.

4 Communiqué, Meeting of Finance Ministers and Central Bank Governors, 19-20 July 2013.

5 ESMA has invited comments on the consultation paper and will consider all those received by 16 September 2013.

6 Title VII of Dodd-Frank purports to apply to activities outside the US which have a "direct and significant connection with activities in, or effect on, commerce in the US", where they are intended to evade US requirements or where a US person (a term that may include foreign companies) is involved. The US CFTC has recently issued final interpretive guidance and a transitional exemptive order on the cross-border application of Dodd-Frank's regulatory requirements, which together provide a final "US Person" definition and address compliance obligations of cross-border swap counterparties. Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap, available at: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister071213b.pdf; Exemptive Order Regarding Compliance with Certain Swap Regulations, available at: http://www.cftc.gov/LawRegulation/DoddFrankAct/Dodd-FrankFinalRules/ssLINK/2013-17467.

We will update clients shortly with an overview of these recent developments in our forthcoming publication on the CFTC cross-border final guidance. If you wish to view further information on regulatory reforms, please refer to our dedicated website.

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