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The Extra-territorial Impact of EMIR on Non-EU Swap Counterparties

By Sean Donovan-Smith, Paul Matthews, Stephen Moller, Anthony R.G. Nolan and Alice Bell

On November 18, 2013, the European Securities and Markets Authority (“**ESMA**”) published its final report on technical standards detailing how the regulation of over-the-counter (“**OTC**”) derivative contracts in the European Union (“**EU**”) will apply to contracts that are entered into or performed outside the EU or involve at least one counterparty that is not organised under the law of an EU Member State (the “**November RTS**”).¹

Given that derivatives markets are global in nature, firms that use OTC derivative contracts have been continuing to monitor the potential extra-territorial impact of the European Markets Infrastructure Regulations (“**EMIR**”).² The November RTS provides international OTC derivative market participants with guidance regarding the circumstances in which OTC derivative contracts outside the EU will be considered to have a “direct, substantial and foreseeable effect” in the EU and thus be subject to EMIR.

This article describes the potential application of EMIR (as implemented by the November RTS) to OTC derivatives markets participants located outside the EU, focussing in particular on the meaning of the term, “direct, substantial and foreseeable effect”, and on the scope of the anti-avoidance provisions under EMIR as clarified by the November RTS.

Background

EMIR was published in the Official Journal of the EU on July 27, 2012 and entered into force on August 16, 2012. EMIR is similar to the United States’ (“**U.S.**”) Dodd-Frank Wall Street Reform and Consumer Protection Act (the “**Dodd-Frank Act**”).³ Like the Dodd-Frank Act, EMIR was introduced to implement the G-20 agreement to promote transparency and to reduce risk in OTC derivative markets.⁴

To achieve this objective, EMIR introduces trade reporting and provides for the obligation to centrally clear OTC derivative contracts and to apply risk mitigation techniques, such as using timely confirmations, regular portfolio reconciliation and compression, implementing dispute resolution procedures, using mark-to-market values where possible and implementing procedures for the exchange of collateral (collectively referred to in this article as “risk mitigation techniques”). EMIR has been supplemented with a number of regulatory technical standards (the first of which were published in September 2012) which have been adopted by the European Commission (the “**Commission**”) and implemented as delegated regulations directly applicable in all EU Member States.

¹ Final Report: Draft technical standards under EMIR on contracts having a direct, substantial or foreseeable effect within the Union and non-evasion (ESMA/2013/1657).

² Regulation No. 648/2012.

³ For our client alert on the cross-border application of U.S. swaps regulation, [click here](#).

⁴ For our client alert on Title VII of the Dodd-Frank Act that was published when that statute was enacted into law, [click here](#).

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The Scope of EMIR

The extent to which EMIR applies to counterparties to derivative transactions depends on whether the counterparty is established in the EU, and whether it is a Financial Counterparty⁵ or a Non-financial Counterparty⁶ (and, if a Non-financial Counterparty, how much derivative trading it carries out).

EMIR generally applies to all derivative contracts, central counterparties (“**CCPs**”), Financial Counterparties, trade repositories and, in certain circumstances, to Non-financial Counterparties and trading venues. Non-financial Counterparties are further categorised by the size of their trading activity (subject to exceptions for hedging purposes): Non-financial Counterparties whose trading activity exceeds €1 billion in gross notional value for OTC credit and equity derivatives, or €3 billion in gross notional value for interest rate, foreign exchange, commodities and other derivatives are categorised as “**NFC+ Counterparties**”.

The clearing and risk mitigation provisions of EMIR may apply to non-EU counterparties in certain circumstances. However, as discussed below, EMIR and the November RTS provide for “equivalency” mechanisms to avoid duplicative or conflicting rules, which are in principle similar to the concept of substituted compliance in U.S. regulation under the Dodd-Frank Act.

Application of the EMIR Clearing Obligations

The EMIR clearing obligation will apply to standardised OTC derivative contracts between:

- i. EU Financial Counterparties and/or NFC+Counterparties; or
- ii. either an EU Financial Counterparty or an NFC+ counterparty and a non-EU entity that would fall within the definition of a Financial Counterparty or a NFC+ Counterparty if such non-EU entity was established in the EU; or
- iii. two Non-EU counterparties that would each be either a Financial Counterparty or NFC+ Counterparty were they established in the EU, provided the contract has a “direct, substantial and foreseeable effect” within the EU⁷ or otherwise where necessary or appropriate to prevent the evasion of EMIR.⁸

⁵ The term “financial counterparty” covers several types of entity regulated by EU financial services legislation (“**Financial Counterparty**”). That is, any investment firm that is authorised under the EU’s Markets in Financial Instruments Directive (“**MiFID**”); any UCITS fund and its related management company; credit institutions; insurance companies; and alternative investment funds managed by alternative investment fund managers authorised or registered under the EU’s Alternative Investment Fund Managers Directive (“**AIFMD**”).

⁶ The term “non-financial counterparty” covers an entity established in the EU that is not a Financial Counterparty (“**Non-financial Counterparty**” or “**NFC**”).

⁷ Article 4(1)(a)(v) EMIR. Counterparties to an OTC derivative contract subject to EMIR will likely be required to consider adhering to the ISDA 2013 EMIR NFC Representation Protocol. For our alert addressing some factors to be considered in deciding whether or not to adhere to that the merits and demerits of adhering to this protocol in particular cases, please [click here](#).

⁸ Article 11(12) EMIR.

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	NFC	NFC+	FC	Non-EU "NFC"	Non-EU "NFC+"	Non-EU "FC"
NFC	x	x	x	x	x	x
NFC+	x	✓	✓	x	✓	✓
FC	x	✓	✓	x	✓	✓
Non-EU "NFC"	x	x	x	x	x	x
Non-EU "NFC+"	x	✓	✓	x	✓*	✓*
Non-EU "FC"	x	✓	✓	x	✓*	✓*

*only if a "direct, substantial and foreseeable effect" within the EU or for anti-avoidance purposes.

Application of the EMIR Risk Mitigation Techniques

The requirement under EMIR to employ risk mitigation techniques applies when OTC derivative contracts that are not cleared by a CCP are concluded between:

- i. EU Financial Counterparties and Non-financial Counterparties; or
- ii. a non-EU entity and an EU Financial Counterparty or Non-financial Counterparty on the basis that the relevant EU counterparty is itself subject to the EMIR risk mitigation techniques requirements;⁹ or
- iii. non-EU entities that would each be either a Financial Counterparty or Non-financial Counterparty if they were established in the EU, provided the contract has a "direct, substantial and foreseeable effect" within the EU, or otherwise where necessary or appropriate to prevent the evasion of EMIR.¹⁰ (Note that different risk mitigation techniques apply to Non-financial Counterparties depending on whether they are a Non-financial Counterparty or a NFC+ Counterparty.)

⁹ N.B. the obligation under EMIR attaches to the counterparties and not to the contract. In this scenario, the non-EU counterparty is not directly within scope of EMIR and need only have in place compliant procedures to the extent it wishes to transact with EU counterparties who are directly within scope.

¹⁰ Article 11(12) EMIR.

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	NFC	FC	Non-EU "NFC"	Non-EU "FC"
NFC	✓	✓	✓*	✓*
FC	✓	✓	✓*	✓*
Non-EU "NFC"	✓*	✓*	✓**	✓**
Non-EU "FC"	✓*	✓*	✓**	✓**

* The non-EU counterparty is only indirectly caught.

** Only if a "direct, substantial and foreseeable effect" within the EU or for anti-avoidance purposes.

Direct, substantial and foreseeable effect in the EU

The November RTS provide that the clearing obligation would only apply when the two non-EU counterparties' jurisdictions' rules are not considered equivalent to EMIR¹¹ and where one of the following conditions are met:

- the contract is guaranteed by an EU Financial Counterparty; or
- the transaction is executed via the EU branches of the two non-EU counterparties.

Guarantees

The November RTS provide that if an OTC derivative contract is entered into by a non-EU counterparty benefiting from a guarantee issued by an EU Financial Counterparty, the OTC derivative contract will be deemed to have a direct effect in the EU – i.e., where the guarantor is established. This reflects ESMA's view that, where a swap between non-EU counterparties is guaranteed by an EU guarantor, the default of the guaranteed counterparty would have a direct effect on the EU guarantor, which would be obliged to assume the resulting liability.

The definition of "guarantee" contained in the November RTS refers to "explicitly documented legal obligation[s]" and therefore excludes implicit guarantees and letters of comfort (unless drafted as a legal obligation of the issuer), credit derivatives (already covered by EMIR) and contracts of insurance.

In order for a guaranteed OTC derivative contract to be covered by the November RTS, the guarantee must cover OTC derivatives contracts with a gross notional amount of at least €8 billion and the guaranteed obligations must represent at least 5 percent of the aggregate current exposure of the guarantor on OTC derivatives contracts. (Where a guarantee covers a percentage of the liability resulting from an OTC derivative contract, the proportion of the notional amount covered by the guarantee will be counted toward the €8 billion threshold described above.) ESMA rejected suggestions raised in its consultation that the threshold should be calculated on a net basis.

The calculations should be applied to individual legal entities rather than at the group level, and a proportionate amount should be applied if the guarantee is split across several guarantors.

¹¹ Pursuant to the mechanisms to avoid duplicative or conflicting rules, under Article 13 of EMIR and recital (2) of the November RTS (i.e., equivalence).

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The November RTS only capture guarantees that have been issued by a Financial Counterparty (i.e., established in the EU). Despite requests from industry stakeholders during the consultation period that ESMA restrict this further to Financial Counterparties that are parents of the guaranteed non-EU counterparty, the November RTS do not require an affiliation between the guarantor and the guaranteed entity.

Note that OTC derivative contracts concluded after August 16, 2012 but which subsequently are covered by an applicable guarantee will nevertheless be counted towards the cumulative quantitative threshold if they are considered to have a direct, substantial and foreseeable effect in the EU (and are thereby potentially subject to EMIR).

Branches

In determining whether OTC transactions by the EU branch of a non-EU entity are subject to EMIR, the November RTS adopts a rule based on the location and identity of the branch's counterparty.

If the EU branch of a non-EU entity transacts either with an EU entity or with the EU branch of another non-EU entity, the November RTS will cause that derivative contract to be deemed to have a direct effect on the EU and thereby fall within the scope of EMIR. ESMA's reasoning for this rule is that such EU branches may not be caught by non-EU regimes and the non-EU entity's jurisdiction may not be equivalent to Europe, potentially leading to a loophole, with a consequential direct effect in the EU.

On the other hand, EMIR will not apply to an OTC derivative contract between an EU branch of a non-EU entity and another non-EU entity pursuant to the November RTS because ESMA considers such a scenario to be a cross-border transaction that does not have a direct effect in the EU.

Non-evasion of EMIR

The November RTS use a "primary purpose" criteria-based approach to define the types of OTC derivative transactions that are deemed to be concluded for the purpose of circumventing EMIR.

The November RTS provide that an OTC derivative contract with the primary purpose of avoiding provisions of EMIR that would otherwise apply will be caught by the evasion provision, for example, if the contract is part of an "artificial arrangement". An artificial arrangement is one *"that intrinsically lacks business rationale, commercial substance or relevant economic justification"*. When determining the "primary purpose" of a contract, the November RTS stipulate that the way in which the contract was concluded should be viewed as a whole and with regard to all the circumstances. This determination will need to be made on a case-by-case basis.

Timing

The November RTS will only take effect once adopted by the European Commission and they subsequently enter into force.¹² Accordingly, the clearing and risk mitigation obligations will not apply to non-EU counterparties who enter into OTC derivative contracts having a "direct, substantial and foreseeable effect" within the EU or to those deemed to be concluded for the purpose of evading EMIR until such time. However, Non-EU counterparties may nonetheless inadvertently be caught by the risk mitigation

¹² Pursuant to Recital 93 of EMIR.

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obligation if they transact with EU counterparties who are themselves required to comply, because such counterparties must have written agreements in place with their counterparties, dealing with the risk mitigation obligations.

The European Commission has until February 15, 2014 to decide whether to endorse the November RTS and, provided it does endorse the November RTS (which is expected), the European Commission must then submit the endorsed standards to the European Parliament and the Council of Europe. The November RTS would then enter into force 20 days after publication in the Official Journal of the EU, but the provisions relating to contracts that have a direct, substantial and foreseeable effect in the EU would be subject to a transition period of six months.

With the exception of the cumulative quantitative threshold for guarantees, the provisions relating to contracts having a direct, substantial and foreseeable effect in the EU will only apply to OTC derivative contracts entered into after the November RTS take effect.

Equivalence / Substituted Compliance

Because of the global nature of OTC derivatives markets and the firms that participate in them, many market participants have been very concerned about the risk that they could be subject to duplicative or conflicting rules. In certain circumstances, the EMIR clearing and risk mitigation obligations may be substituted by equivalent requirements in third countries for cross-border transactions and transactions between two third country entities.

EMIR and the November RTS acknowledge those concerns by addressing the need to give due consideration to the mechanism to avoid duplicative or conflicting rules provided by EMIR, which is based on equivalence of the legal, supervisory and enforcement arrangements of third countries. The November RTS make clear that, if one of the two counterparties to a transaction is established in a third country for which the Commission has adopted an implementing act declaring that third country to be equivalent, both counterparties to the relevant transaction will be deemed to have complied with EMIR by applying the equivalent rules of the third country.¹³ This is in principle similar to the notion of “substituted compliance” articulated by U.S. regulators such as the Commodity Futures Trading Commission (the “**CFTC**”) and the Securities and Exchange Commission. However, the scope and application of mechanisms for equivalence in the EU or substituted compliance in the U.S. are not identical.

ESMA has stated that close cooperation between supervisors is required to regulate derivative markets in an efficient and adequate manner and to address risks while preventing duplication and overlap of regulation or regulatory gaps. ESMA’s determination of the availability of relief to avoid duplicative regulation will likely be based on its evaluation of the timing and scope of the solutions put forth by competent regulatory authorities in particular jurisdiction.¹⁴

An important further development will be the negotiations among regulators internationally, particularly between those in the EU and those in the U.S., to determine the details governing decisions on equivalence and the circumstances under which an entity’s compliance with its home country regulations will be deemed to be compliant with the regulations being applied with extraterritorial effect. In order to avoid the risk that the

¹³ Article 13 of EMIR and recital (2) of the November RTS.

¹⁴ As at the date of this article, ESMA has provided the Commission with technical advice on the equivalence of nine countries (Australia, Canada, Hong Kong, India, Japan, Singapore, South Korea, Switzerland and the U.S.). By way of comparison, the CFTC has identified Australia, Canada, the EU, Hong Kong, Japan, and Switzerland as having regulations that may qualify for substituted compliance.

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OTC derivatives market may fragment along regional or national lines, it will be particularly important for the Commission to take appropriate equivalence decisions with respect to, and for ESMA to grant recognition of, CCPs located outside the EU, just as it will be important for the CFTC to take appropriate targeted no-action relief with respect to CCPs located outside the U.S.¹⁵ To ensure the seamless working of the clearing mechanism for OTC derivatives and swaps, and to avoid uncertainty around clearing obligations, the Commission and the CFTC must endeavour to ensure that those infrastructures will be able to clear swaps/derivatives for their clearing members until registration/recognition has been determined. The EU can achieve this through the Commission's equivalence decisions and ESMA's recognition of foreign CCPs, while the CFTC can do this through targeted no-action relief.

Conclusion

The publication of the November RTS marks an important step in the development of a regulatory scheme for OTC derivatives in the EU. Firms that deal in OTC derivative contracts should review their arrangements to determine whether they are within the scope of EMIR and to ensure that they are aware of any obligations that may apply to them. Firms based outside the EU but who transact with counterparties in the EU or through branches located in the EU should consider their OTC derivatives trading activities with care to ensure that their transactions are consistent with EU regulation, including through making of appropriate EMIR protocol representations.

Key Contacts:

Sean Donovan-Smith

sean.donovan-smith@klgates.com
+44.(0)20.7360.8202

Paul Matthews

paul.matthews@klgates.com
+44.(0).20.7360.8214

Anthony R. G. Nolan

anthony.nolan@klgates.com
+1.(212).536.4843

Alice Bell

alice.bell@klgates.com
+44.20.7360.8304

Stephen Moller

stephen.moller@klgates.com
+44.20.7360.8212

¹⁵ As at the date of this article two EU CCPs (LCH.Clearnet Ltd. and ICE Clear Europe) are already registered with the CFTC as derivatives clearing organizations under the Dodd-Frank Act. We understand that the CFTC's Division of Clearing and Risk plans to issue no-action letters to Eurex Clearing AG and LCH.Clearnet SA, both of which have pending registration applications with the CFTC, to begin clearing interest rate swaps and/or credit default swap indices for U.S. clearing members.

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